

Hilltop Holdings Inc.
Form 10-Q
November 06, 2009

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2009

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

Commission File Number: 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or
organization)

84-1477939

(I.R.S. Employer Identification No.)

200 Crescent Court, Suite 1330

Dallas, Texas

(Address of principal executive offices)

75201

(Zip Code)

(214) 855-2177

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a
smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the Registrant's common stock outstanding at November 6, 2009 was 56,485,405.

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FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2009**

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HILLTOP HOLDINGS INC.
CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2009 AND DECEMBER 31, 2008
(in thousands, except share and per share data)
(unaudited)

| | September 30, 2009 | December 31, 2008 |
|--|-----------------------|----------------------|
| Assets | | |
| Investments | | |
| Fixed maturities | | |
| Available for sale securities, at fair value (amortized cost of \$360,268 and \$116,207 , respectively) | \$ 366,210 | \$ 115,336 |
| Held-to-maturity securities, at amortized cost (fair value of \$17,693 and \$17,738, respectively) | 16,817 | 16,406 |
| Equity securities | | |
| Available for sale securities, at fair value (cost of \$7,643 and \$7,470, respectively) | 8,763 | 6,826 |
| Total investments | 391,790 | 138,568 |
| Cash and cash equivalents | 527,760 | 749,376 |
| Restricted cash | | 18,500 |
| Accrued interest and dividends | 1,329 | 1,551 |
| Premiums receivable | 22,469 | 20,462 |
| Deferred acquisition costs | 16,556 | 15,935 |
| Reinsurance recoverable, net of uncollectible amounts | 19,162 | 16,944 |
| Prepaid reinsurance premiums | 4,920 | 4,782 |
| Income taxes receivable | 2,571 | 24,598 |
| Deferred income taxes | 12,045 | 14,966 |
| Goodwill | 23,988 | 23,988 |
| Intangible assets, definite life | 9,679 | 11,002 |
| Intangible assets, indefinite life | 3,000 | 3,000 |
| Property and equipment, net | 1,552 | 350 |
| Loan origination costs, net | 3,117 | 3,265 |
| Other assets | 1,480 | 1,483 |
| Total Assets | \$ 1,041,419 | \$ 1,048,770 |

Table of Contents**HILLTOP HOLDINGS INC.****CONSOLIDATED BALANCE SHEETS****AS OF SEPTEMBER 30, 2009 AND DECEMBER 31, 2008 (Continued)****(in thousands, except share and per share data)****(unaudited)**

| | September 30, 2009 | December 31, 2008 |
|--|-----------------------|----------------------|
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Reserve for losses and loss adjustment expenses | \$ 32,469 | \$ 34,023 |
| Unearned premiums | 71,167 | 68,451 |
| Reinsurance payable | 367 | 781 |
| Accounts payable and accrued expenses | 7,169 | 9,306 |
| Notes payable | 138,368 | 138,368 |
| Dividends payable | 1,719 | 1,719 |
| Other liabilities | 5,988 | 4,667 |
| | | |
| Total liabilities | 257,247 | 257,315 |
| Stockholders' Equity | | |
| Series A preferred stock, \$0.01 par value, 5,750,000 shares authorized, 5,000,000 shares issued and outstanding at September 30, 2009 and December 31, 2008; liquidation preference of \$25 per share plus accrued but unpaid dividends | 119,108 | 119,108 |
| Common stock, \$0.01 par value, 100,000,000 shares authorized, 56,482,952 and 56,455,515 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively | 564 | 564 |
| Additional paid-in capital | 917,851 | 917,682 |
| Accumulated other comprehensive income (loss) | 4,590 | (985) |
| Accumulated deficit | (257,941) | (244,914) |
| | | |
| Total stockholders' equity | 784,172 | 791,455 |
| | | |
| Total liabilities and stockholders' equity | \$ 1,041,419 | \$ 1,048,770 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**HILLTOP HOLDINGS INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008****(in thousands, except share and per share data)****(unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---------------|--|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Revenue: | | | | |
| Net premiums earned | \$ 29,150 | \$ 22,745 | \$ 86,216 | \$ 83,017 |
| Net investment income | 1,491 | 6,716 | 4,947 | 21,887 |
| Other income | 1,879 | 1,503 | 5,150 | 4,674 |
| Net realized gains (losses) on investments | | | | |
| Other-than-temporary impairments on fixed maturity securities | | (79) | (841) | (41,957) |
| Other realized investment gains (losses), net | 161 | (1,134) | 200 | (950) |
| Total realized investment gains (losses), net | 161 | (1,213) | (641) | (42,907) |
| Total revenue | 32,681 | 29,751 | 95,672 | 66,671 |
| Expenses: | | | | |
| Loss and loss adjustment expenses | 15,051 | 29,946 | 57,012 | 69,228 |
| Policy acquisition and other underwriting expenses | 10,333 | 10,736 | 32,616 | 32,350 |
| General and administrative expenses | 1,713 | 1,750 | 5,256 | 7,207 |
| Depreciation and amortization | 492 | 532 | 1,495 | 1,628 |
| Interest expense | 2,473 | 2,617 | 7,431 | 7,925 |
| Total expenses | 30,062 | 45,581 | 103,810 | 118,338 |
| Income (Loss) before income tax (expense) benefit | 2,619 | (15,830) | (8,138) | (51,667) |
| Income tax (expense) benefit | (936) | 10,168 | 2,846 | 22,694 |
| Net income (loss) | 1,683 | (5,662) | (5,292) | (28,973) |
| Preferred stock dividend | (2,579) | (2,579) | (7,735) | (7,735) |
| Net loss attributable to common stockholders | \$ (896) | \$ (8,241) | \$ (13,027) | \$ (36,708) |
| Loss per share attributable to common stockholders | | | | |
| Basic loss per share | \$ (0.02) | \$ (0.15) | \$ (0.23) | \$ (0.65) |
| Diluted loss per share | \$ (0.02) | \$ (0.15) | \$ (0.23) | \$ (0.65) |
| Weighted average share information | | | | |
| Basic shares outstanding | 56,483 | 56,452 | 56,470 | 56,452 |
| Diluted shares outstanding | 56,483 | 56,452 | 56,470 | 56,452 |

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009

(in thousands)

(unaudited)

| | Preferred Stock | | Common Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive (Loss) Income | Accumulated Deficit | Total Stockholders' Equity |
|--|-----------------|------------|--------------|--------|----------------------------------|---|------------------------|----------------------------------|
| | Shares | Amount | Shares | Amount | | | | |
| Balance, January 1, 2009 | 5,000 | \$ 119,108 | 56,456 | \$ 564 | \$ 917,682 | \$ (985) | \$ (244,914) | \$ 791,455 |
| Net loss | | | | | | | (5,292) | (5,292) |
| Preferred stock dividends declared | | | | | | | (7,735) | (7,735) |
| Accumulated other comprehensive income, net of tax | | | | | | 5,575 | | 5,575 |
| Total comprehensive loss | | | | | | | | (7,452) |
| Common stock issued to board members | | | 10 | | 106 | | | 106 |
| Options Exercised | | | 17 | | | | | |
| Stock compensation expense | | | | | 63 | | | 63 |
| Balance, September 30, 2009 | 5,000 | \$ 119,108 | 56,483 | \$ 564 | \$ 917,851 | \$ 4,590 | \$ (257,941) | \$ 784,172 |

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008

(in thousands)

(unaudited)

| | For the Nine Months Ended September 30, | |
|---|--|-------------|
| | 2009 | 2008 |
| Cash flow from operating activities: | | |
| Net loss | \$ (5,292) | \$ (28,973) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,495 | 1,628 |
| Deferred income taxes | (81) | 6,988 |
| Increase in unearned premiums | 2,716 | 4,084 |
| Increase in deferred acquisition costs | (621) | (2,366) |
| Realized losses on investments | 641 | 42,907 |
| Amortization of loan origination costs | 148 | 148 |
| Stock grant compensation expense | 169 | 35 |
| Increase (decrease) in payable to related party | 872 | (329) |
| Decrease in income taxes receivable | 22,027 | (10,634) |
| Changes in operating assets and liabilities | (7,271) | (16,930) |
| Net cash provided by (used in) operating activities | \$ 14,803 | \$ (3,442) |
| Cash flow from investing activities: | | |
| Purchases of fixed assets | (1,375) | (59) |
| Restricted cash | 18,500 | (18,500) |
| Purchases of available-for-sale securities | (1,089,832) | (39,801) |
| Purchases of held-to-maturity securities | (206) | (7,926) |
| Purchase of NALICO GA | | (375) |
| Proceeds from sales of available-for-sale securities | 9,252 | 32,003 |
| Proceeds from maturities of available-for-sale securities | 834,745 | 11,244 |
| Proceeds from maturities of held-to-maturity securities | 232 | 6,156 |
| Net cash used in investing activities | \$ (228,684) | \$ (17,258) |
| Cash flow from financing activities: | | |
| Repayment of debt | | (4,000) |
| Payment of preferred dividends | (7,735) | (7,735) |
| Net cash used in financing activities | (7,735) | (11,735) |
| Net decrease in cash and cash equivalents | (221,616) | (32,435) |
| Cash and cash equivalents, beginning of period | 749,376 | 783,008 |
| Cash and cash equivalents, end of period | \$ 527,760 | \$ 750,573 |
| Non-cash financing and investing transactions: | | |
| Dividends declared but unpaid | \$ 1,719 | \$ 1,719 |

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Supplemental cash flow information:

| | | | | |
|----------------------------|----|-------|----|--------|
| Cash paid for interest | \$ | 8,708 | \$ | 9,527 |
| Cash paid for income taxes | \$ | | \$ | 10,634 |

The accompanying notes are an integral part of these consolidated financial statements.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2009

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies

Business

Hilltop Holdings Inc. is a holding company that is endeavoring to make opportunistic acquisitions. In connection with that strategy, we are identifying and evaluating potential targets on an ongoing basis. We also conduct operations in the property and casualty insurance industry through our insurance subsidiaries, National Lloyds Insurance Company and American Summit Insurance Company. National Lloyds Insurance Company commenced business in 1949 and currently operates in 15 states, with its largest market being the State of Texas. National Lloyds Insurance Company carries a financial strength rating of "A" (Excellent) by A.M. Best. American Summit Insurance Company was formed in 1955 and currently operates in 12 states, its largest market being the State of Arizona. American Summit Insurance Company carries a financial strength rating of "A-" (Excellent) by A.M. Best. Both of these insurance companies are regulated by the Texas Department of Insurance.

Our common stock is listed on the New York Stock Exchange under the symbol "HTH". Our Series A Cumulative Redeemable Preferred Stock is listed on the New York Stock Exchange under the symbol "HTH-PA". We have no public trading history prior to February 12, 2004.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America ("GAAP"), and in conformity with the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP, however, have been condensed or omitted pursuant to Article 10 of Regulation S-X. The consolidated financial statements include the accounts of all wholly-owned subsidiaries of the Company. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

Certain accounts have been reclassified to conform to the current period's presentation. In the opinion of management, these financial statements have been prepared on the same basis as the audited consolidated financial statements and include all adjustments necessary for the fair presentation of the Company's financial position, results of operations and cash flows. These adjustments were of a normal, recurring nature. The results of operations for the interim period ended September 30, 2009 are not indicative of the results that may be expected for the year ended December 31, 2009. These financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K and 10-K/A for the year ended December 31, 2008.

We are required by GAAP to make estimates and assumptions that affect our reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of our financial statements and our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. These estimates and assumptions are particularly important in determining revenue recognition, reserves for losses and loss adjustment expenses, deferred policy acquisition costs, reinsurance receivables and potential impairment of assets.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies (Continued)

Summary of Significant Accounting Policies

Restricted Cash

On January 5, 2009, the third party loan for which we provided a guaranty and designated as restricted cash of \$18.5 million was repaid in full, thus relieving us of any further obligation. At September 30, 2009, we had no cash and cash equivalents designated as restricted.

Recently Adopted Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB) issued guidance on the disclosure of derivative and hedging activities. The new guidance, which is now part of ASC 815, *Derivatives and Hedging*, requires enhanced disclosures about an entity's derivative and hedging activities and strives to improve the transparency of financial reporting. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company currently holds no derivative instruments and has no hedging activities; therefore, there is no impact of adopting ASC 815 on its financial statements.

In April 2008, FASB issued revised guidance on the determination of the useful life of intangible assets, which is now a part of ASC 350, *Intangibles Goodwill and Other*. The new guidance amends the factors that an entity should consider in determining the useful life of a recognized intangible asset to include the entity's historical experience in renewing or extending similar arrangements, whether or not the arrangements have explicit renewal or extension provisions. Previously, an entity was precluded from using its own assumptions about renewal or extension of an arrangement where there was likely to be substantial cost or modifications. Entities without their own historical experience should consider the assumptions market participants would use about renewal or extension. The revised guidance may result in the useful life of an entity's intangible asset differing from the period of expected cash flows that was used to measure the fair value of the underlying asset using the market participant's perceived value. Disclosure to provide information on an entity's intent and/or ability to renew or extend the arrangement is also required.

The revised guidance was effective for financial statements issued for fiscal years beginning after December 15, 2008 and for interim periods within those fiscal years. The adoption of the revised guidance on January 1, 2009 did not have a material effect on the Company's results of operations, financial position or liquidity and did not require additional disclosures related to existing intangible assets.

In December 2007, FASB issued revised guidance for the accounting for business combinations. The revised guidance, which is now part of ASC 805, *Business Combinations*, significantly changes the financial accounting and reporting of business combination transactions. ASC 805 establishes principles

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies (Continued)

for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance is effective for acquisition dates on or after the beginning of an entity's first fiscal year that begins after December 15, 2008. The Company has not had any business combination transactions since the effective date; therefore, there is no impact of adopting on its current financial statements.

In January 2009, FASB issued revised guidance for measuring and recognizing pre-acquisition contingencies in a business combination. The revised guidance, which is now part of ASC 805, *Business Combinations*, requires that an asset or a liability arising from a contingency in a business combination be recognized at fair value if fair value can be reasonably determined and provides guidance on how to make that determination. If the fair value of an asset or liability cannot be reasonably determined, the guidance requires that an asset or liability be recognized at the amount that would be recognized in accordance with ASC 450, *Contingencies*, and FIN 14, Reasonable Estimation of the Amount of a Loss, for liabilities and an amount using a similar criteria for assets. The ASC 805 revision also amends the subsequent measurement and accounting guidance and the disclosure requirements for assets and liabilities arising from contingencies in a business combination. FASB is proposing that the guidance be effective for assets or liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company does not have any assets or liabilities arising from a contingency in a business combination; therefore, there is no impact of adopting ASC 805 on its financial statements.

In December 2007, FASB issued new guidance for the accounting for noncontrolling interests. The new guidance, which is now part of ASC 810, *Consolidation*, significantly changes the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. The new guidance is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption permitted. The Company does not have any noncontrolling interests in its consolidated financial statements; therefore, there is no impact of adopting ASC 810 on its financial statements.

In April 2009, FASB issued new guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. The new guidance, which is now part of ASC 820, *Fair Value Measurements and Disclosures*, affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. The guidance requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. It also requires disclosures of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, for both interim and annual periods. This standard is effective for interim and annual periods ending after June 15, 2009. There was no material impact on our financial statements as a result of adopting the standard effective second quarter of 2009.

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies (Continued)

In April 2009, FASB issued new guidance for the recognition and presentation of other-than-temporary impairments. This new guidance, which is now part of ASC 320, *Investments-Debt and Equity Securities*, (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. This new guidance declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. This standard is effective for interim periods ending after June 15, 2009. There was no material impact as a result of adopting ASC 320 effective second quarter of 2009.

In April 2009, FASB issued new guidance related to the disclosure of the fair value of financial instruments. This new guidance, which is now part of ASC 825, *Financial Instruments*, and ASC 270, *Interim Reporting*, requires an entity to provide disclosures about fair value of financial instruments in interim financial information and requires those disclosures in summarized financial information at interim reporting periods. Under ASC 825 and ASC 270, a publicly traded company shall include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. In addition, entities must disclose, in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods, the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position. This standard is effective for interim and annual periods ending after June 15, 2009. The new interim disclosures required by ASC 825 and ASC 270 are included in these notes to the consolidated financial statements.

In May 2009, FASB issued SFAS new guidance on subsequent events, which is now part of ASC 855, *Subsequent Events*. This established standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The standard is based on the same principles that currently exist but has included a required disclosure of the date though which the entity has evaluated subsequent events. The standard was effective for interim and annual filings ending after June 15, 2009 and has been adopted by the Company as of June 30, 2009. The required disclosures, if any, have been included in these notes to the consolidated financial statements.

In June 2009, FASB issued new guidance on accounting standards and codification, which is now part of ASC 105, *Generally Accepted Accounting Principles*. This will serve as the single source of authoritative non-governmental GAAP. Accordingly, all other accounting literature not included is considered non-authoritative. This is effective on a prospective basis for interim and annual periods ending after September 15, 2009. There was no material impact as a result of adopting ASC 105 effective third quarter 2009.

HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies (Continued)

In August 2009, FASB issued new guidance for the accounting for the fair value measurement of liabilities. The new guidance, which is now part of ASC 820-10, provides clarification that in certain circumstances in which a quoted price in an active market for the identical liability is not available, a company is required to measure fair value using one or more of the following valuation techniques: the quoted price of the identical liability when traded as an asset, the quoted prices for similar liabilities or similar liabilities when traded as assets, and/or another valuation technique that is consistent with the principles of fair value measurements. The new guidance clarifies that a company is not required to include an adjustment for restrictions that prevent the transfer of the liability and if an adjustment is applied to the quoted price used in a valuation technique, the result is a Level 2 or 3 fair value measurement. The new guidance is effective for interim and annual periods beginning after August 27, 2009. There was no material impact as a result of adopting ASC 820-10 effective third quarter 2009.

Recently Issued Accounting Pronouncements

In June 2009, FASB issued new guidance on the accounting for the transfers of financial assets. The new guidance, which was issued as Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140*, has not yet been adopted into Codification. The new guidance requires additional disclosures for transfers of financial assets, including securitization transactions, and any continuing exposure to the risks related to transferred financial assets. There is no longer a concept of a qualifying special-purpose entity, and the requirements for derecognizing financial assets have changed. The new guidance is effective on a prospective basis for the annual period beginning after November 15, 2009, and interim and annual periods thereafter. The Company does not expect that the provisions of the new guidance will have a material effect on its results of operations, financial position or liquidity.

In June 2009, FASB issued revised guidance on the accounting for variable interest entities. The revised guidance, which was issued as Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)*, has not yet been adopted into Codification. The revised guidance reflects the elimination of the concept of a qualifying special-purpose entity and replaces the quantitative-based risks and rewards calculation of the previous guidance for determining which company, if any, has a controlling financial interest in a variable interest entity. The revised guidance requires an analysis of whether a company has: (1) the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb the losses that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity. An entity is required to be re-evaluated as a variable interest entity when the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights to direct the activities that most significantly impact the entity's economic performance. Additional disclosures are required about a company's involvement in variable interest entities and an ongoing assessment of whether a company is the primary beneficiary. FAS 167 is effective for interim and annual periods that begin after November 15, 2009. The Company does not expect that the adoption of FAS 167 will impact the Company's results of operations, financial position or liquidity.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****2. Investments**

The amortized cost (original cost for equity securities), gross unrealized holding gains and losses, and fair value of available-for-sale and held-to-maturity securities by major security type and class of security at September 30, 2009 and December 31, 2008 were as follows (in thousands).

| | September 30, 2009 | | | |
|---------------------------------------|--|---|--|-----------------------|
| | Cost and Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Available-for-sale securities: | | | | |
| Fixed maturities: | | | | |
| Government securities | \$ 277,669 | \$ 1,736 | \$ (199) | \$ 279,206 |
| Commercial mortgage-backed securities | 10,951 | 747 | | 11,698 |
| Corporate debt securities | 71,648 | 4,157 | (499) | 75,306 |
| | 360,268 | 6,640 | (698) | 366,210 |
| Equity securities | 7,643 | 1,126 | (6) | 8,763 |
| | 367,911 | 7,766 | (704) | 374,973 |
| Held-to-maturity securities: | | | | |
| Fixed maturities: | | | | |
| Government securities | 16,817 | 876 | | 17,693 |
| | \$ 384,728 | \$ 8,642 | \$ (704) | \$ 392,666 |

| | December 31, 2008 | | | |
|---------------------------------------|--|---|--|-----------------------|
| | Cost and Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Available-for-sale securities: | | | | |
| Fixed maturities: | | | | |
| Government securities | \$ 31,707 | \$ 1,835 | \$ (738) | \$ 32,804 |
| Commercial mortgage-backed securities | 12,917 | 540 | (37) | 13,420 |
| Corporate debt securities | 71,583 | 868 | (3,339) | 69,112 |
| | 116,207 | 3,243 | (4,114) | 115,336 |
| Equity securities | 7,470 | | (644) | 6,826 |
| | 123,677 | 3,243 | (4,758) | 122,162 |
| Held-to-maturity securities: | | | | |
| Fixed maturities: | | | | |
| Government securities | 16,406 | 1,332 | | 17,738 |

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\$ 140,083 \$ 4,575 \$ (4,758) \$ 139,900

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****2. Investments (Continued)**

The following table summarizes the length of time securities with unrealized losses at September 30, 2009 have been in an unrealized loss position (in thousands).

| | Less than 12 Months | | 12 Months or More | | Total | |
|--------------------------------|----------------------------|-------------------------------|----------------------------|-------------------------------|----------------------------|-------------------------------|
| | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses |
| Available-for-sale securities: | | | | | | |
| Fixed maturities: | | | | | | |
| Government securities | \$ 250,986 | \$ (12) | \$ 1,318 | \$ (187) | \$ 252,304 | \$ (199) |
| Corporate debt securities | | | 4,996 | (499) | 4,996 | (499) |
| | 250,986 | (12) | 6,314 | (686) | 257,300 | (698) |
| Equity securities | | | 278 | (6) | 278 | (6) |
| | 250,986 | (12) | \$ 6,592 | \$ (692) | \$ 257,578 | \$ (704) |
| | \$ 250,986 | \$ (12) | \$ 6,592 | \$ (692) | \$ 257,578 | \$ (704) |

For the nine months ended September 30, 2009, the Company took an other-than-temporary impairment on one corporate bond and recognized a loss of \$0.8 million; and, there were no other comprehensive income losses for this impairment in accordance with GAAP for the recognition and presentation of other-than-temporary impairments. There were no other-than-temporary impairments for the three months ended September 30, 2009.

While all of the investments are monitored for potential impairment, our experience indicates that they generally do not present a great risk of impairment, as fair value recovers over time. Management believes that the analysis of each of these investments supports the view that these investments were not other-than-temporarily impaired. Evidence considered in this analysis includes the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the investment portfolio have decreased in value since the date of acquisition, the severity of loss and the duration of the loss position are not significant enough to warrant other-than-temporary impairment of the securities. Since December 31, 2008, the fair market value of the investment portfolio has steadily increased by \$5.6 million. The Company does not intend to sell these securities and it is not likely that the Company will be required to sell these securities before the recovery of the cost basis; and, therefore, does not believe any other-than-temporary impairments exist as of September 30, 2009, other than the security that management identified and impaired.

In conjunction with GAAP, there were no adjustments to previously taken other-than-temporary impairment as a result of credit losses, as the Company believes it is more likely than not that it will sell these securities before recovery of its cost basis.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****2. Investments (Continued)**

Gross realized investment gains and losses for the three and nine months ended September 30, 2009 and 2008 are summarized as follows (in thousands).

| | Three Months Ended September 30, | | | | | |
|-------------------|---|---------------|--------------|--------------|---------------|--------------|
| | 2009 | 2009 | | 2008 | 2008 | |
| | Gross | Gross | Total | Gross | Gross | Total |
| | Gains | Losses | | Gains | Losses | |
| Fixed maturities | \$ 161 | \$ | \$ 161 | \$ 48 | \$ (98) | \$ (50) |
| Equity securities | | | | | (1,163) | (1,163) |
| | \$ 161 | \$ | \$ 161 | \$ 48 | \$ (1,261) | \$ (1,213) |

| | Nine Months Ended September 30, | | | | | |
|-------------------|--|---------------|--------------|--------------|---------------|--------------|
| | 2009 | 2009 | | 2008 | 2008 | |
| | Gross | Gross | Total | Gross | Gross | Total |
| | Gains | Losses | | Gains | Losses | |
| Fixed maturities | \$ 329 | \$ (970) | \$ (641) | \$ 261 | \$ (127) | \$ 134 |
| Equity securities | | | | | (43,041) | (43,041) |
| | \$ 329 | \$ (970) | \$ (641) | \$ 261 | \$ (43,168) | \$ (42,907) |

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities of available-for-sale and held-to-maturity securities at September 30, 2009 and December 31, 2008 by contractual maturity are as follows (in thousands).

| | September 30, 2009 | |
|---|---------------------------|--------------|
| | Amortized | Fair |
| | Cost | Value |
| Available-for-sale fixed maturities: | | |
| Due within one year | \$ 255,076 | \$ 255,189 |
| Due after one year through five years | 47,151 | 49,619 |
| Due after six years through ten years | 38,088 | 40,482 |
| Due after ten years | 9,002 | 9,222 |
| Mortgage-backed securities | 10,951 | 11,698 |
| | \$ 360,268 | \$ 366,210 |

| | | |
|--|----------|----------|
| Held-to-maturity debt securities: | | |
| Due within one year | \$ 3,172 | \$ 3,239 |
| Due after one year through five years | 7,932 | 8,455 |
| Due after six years through ten years | 5,713 | 5,999 |
| Due after ten years | | |

\$ 16,817 \$ 17,693

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****2. Investments (Continued)**

| | December 31, 2008 | |
|---|---------------------------|-----------------------|
| | Amortized Cost | Fair Value |
| Available-for-sale fixed maturities: | | |
| Due within one year | \$ 6,998 | \$ 6,831 |
| Due after one year through five years | 46,584 | 46,647 |
| Due after six years through ten years | 38,259 | 37,457 |
| Due after ten years | 11,449 | 10,981 |
| Mortgage-backed securities | 12,917 | 13,420 |
| | \$ 116,207 | \$ 115,336 |

| | | |
|--|------------------|------------------|
| Held-to-maturity debt securities: | | |
| Due within one year | \$ 165 | \$ 167 |
| Due after one year through five years | 10,874 | 11,738 |
| Due after six years through ten years | 5,367 | 5,833 |
| Due after ten years | | |
| | \$ 16,406 | \$ 17,738 |

Net investment income for the three and nine months ended September 30, 2009 and 2008 is as follows (in thousands).

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|------------------------------|---|-----------------|-------------------|--|------------------|--------------------|
| | 2009 | 2008 | Change | 2009 | 2008 | Change |
| Cash equivalents | \$ 47 | \$ 4,846 | \$ (4,799) | \$ 316 | \$ 16,184 | \$ (15,868) |
| Fixed maturities | 1,496 | 1,865 | (369) | 4,697 | 5,366 | (669) |
| Equity securities | 71 | 89 | (18) | 221 | 664 | (443) |
| | 1,614 | 6,800 | (5,186) | 5,234 | 22,214 | (16,980) |
| Other income net of expenses | (123) | (84) | (39) | (287) | (327) | 40 |
| Net investment income | \$ 1,491 | \$ 6,716 | \$ (5,225) | \$ 4,947 | \$ 21,887 | \$ (16,940) |

At September 30, 2009, the Company had on deposit in custody for various State Insurance Departments investments with carrying values totaling \$16.8 million.

3. Fair Value Measurements

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in GAAP for fair value measurements. GAAP defines fair value, establishes a framework for measuring fair value and establishes disclosures about fair value measurements. The framework is based on the inputs used in valuation and gives the highest priority to quoted prices in active markets and

requires that observable inputs be used in the valuations when available. The

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****3. Fair Value Measurements (Continued)**

disclosure of fair value estimates is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows:

Level 1 Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data.

Level 3 Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use.

The capital and credit markets have been experiencing volatility and disruption for more than 18 months. The downward pressure has negatively affected the performance of our investments, which has resulted in the write-down of investments in previous periods. These write-downs, when determined to be other-than-temporary, reduce our earnings for that period. Though market conditions have improved in the last three months, the level of volatility could worsen and there can be no assurance that we will not experience additional losses on our investments and reductions to earnings.

The following table presents the hierarchy used by the Company by asset and liability type to determine their value at September 30, 2009 and December 31, 2008 (in thousands).

| | As of September 30, 2009 | | | |
|--------------------------------------|--------------------------|------------|------------|----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 527,760 | \$ 527,760 | \$ | \$ |
| Available-for-sale fixed maturities | 366,210 | 250,000 | 113,310 | 2,900 |
| Available-for-sale equity securities | 8,763 | 8,763 | | |
| Total | \$ 902,733 | \$ 786,523 | \$ 113,310 | \$ 2,900 |

| | As of December 31, 2008 | | | |
|--|-------------------------|---------|---------|---------|
| | Total | Level 1 | Level 2 | Level 3 |

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| | | | | |
|--------------------------------------|------------|------------|------------|--------|
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 749,376 | \$ 749,376 | \$ | \$ |
| Available-for-sale fixed maturities | 115,336 | | 115,021 | 315 |
| Available-for-sale equity securities | 6,826 | 6,826 | | |
| Total | \$ 871,538 | \$ 756,202 | \$ 115,021 | \$ 315 |

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

3. Fair Value Measurements (Continued)

Level 1 financial assets

The Company's Level 1 investments are limited to cash and cash equivalent balances and actively-traded debt and equity securities. Cash and cash equivalents are carried at amortized cost, which approximates fair value. Fair value of actively traded debt and equity securities are based on unadjusted quoted market prices.

Level 2 financial assets

Some of the Company's fixed maturity securities are classified in Level 2, including private and corporate debt securities, federal agency and municipal bonds, and non-government mortgage and asset-backed securities. Fair values of inactively traded fixed maturities are based on quoted market prices of identical or similar securities or based on observable inputs, such as interest rates, using either a market or income valuation approach and are generally classified as Level 2.

Level 3 financial assets

The Company's Level 3 fixed maturity securities include collateralized mortgage obligations and one corporate debt security. Fair values are based on inputs that are unobservable and significant to the overall fair value measurement, and involve management judgment. Inputs used to determine fair value include market conditions, spread, volatility, structure and cash flows.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****3. Fair Value Measurements (Continued)**

The following table includes a rollforward of the amounts at September 30, 2009 and 2008 for financial instruments classified within Level 3. The classification of a financial instrument within Level 3 is based upon the significance of the unobservable inputs to the overall fair value measurement.

| | Nine Months Ended | |
|-----------------------------|-------------------|-----------|
| | September 30, | |
| | 2009 | 2008 |
| Balance at January 1, | \$ 315 | \$ |
| Net transfers in | 2,506 | |
| Purchases | | |
| Sales | | |
| Realized Gains | | |
| Change in unrealized losses | (585) | |
| Balance at March 31, | 2,236 | |
| Net transfers in | 2,647 | |
| Purchases | | |
| Sales | | |
| Realized gains | | |
| Change in unrealized losses | (368) | |
| Balance at June 30, | 4,515 | |
| Net transfers (out) in | (856) | 14,469 |
| Purchases | | |
| Sales | (841) | |
| Realized gains | | |
| Change in unrealized losses | 82 | (909) |
| Balance at September 30, | \$ 2,900 | \$ 13,560 |

During the three months ended September 30, 2009, the Company had net transfers of (\$0.8) million in commercial mortgage-backed and corporate securities that were classified within Level 3 and transferred to Level 2. The transfers out were primarily due to an increase in the trading activity in the commercial mortgage-backed securities market during the three months ended September 30, 2009.

For the three months ended March 31, 2009 and June 30, 2009, the Company had net transfers of \$2.5 million and \$2.6 million, respectively, in commercial mortgage-backed and corporate securities that were classified within Level 2 and transferred to Level 3. The transfer was primarily due to the trading inactivity in the commercial mortgage-backed securities market during the three months ended March 31, 2009, and the six months ended June 30, 2009.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****3. Fair Value Measurements (Continued)**

All net unrealized losses in the table above are reflected in the accompanying financial statements. Net unrealized losses relate to those financial instruments held by the Company at September 30, 2009.

The following table presents the carrying value and fair value of assets and liabilities where they differ in value at September 30, 2009 and December 31, 2008 (in thousands):

| | September 30, 2009 | |
|-----------------------------------|---------------------------|-----------------------|
| | Carrying Value | Fair Value |
| Financial assets | | |
| Held to maturity fixed maturities | \$ 16,817 | \$ 17,693 |
| Financial liabilities | | |
| Notes payable | \$ 138,368 | \$ 148,208 |

| | December 31, 2008 | |
|-----------------------------------|---------------------------|-----------------------|
| | Carrying Value | Fair Value |
| Financial assets | | |
| Held to maturity fixed maturities | \$ 16,406 | \$ 17,738 |
| Financial liabilities | | |
| Notes payable | \$ 138,368 | \$ 126,426 |

The Company produces an estimate of fair value based on internally developed valuation techniques which are based on a discounted cash flow methodology and incorporates all available relevant observable market inputs.

4. Property and Equipment

The following summarizes property and other fixed assets as of September 30, 2009 and December 31, 2008 (in thousands).

| | September 30, 2009 | December 31, 2008 |
|-------------------------------|-------------------------------|------------------------------|
| Other equipment | 824 | \$ 824 |
| Software | 1,431 | \$ 56 |
| Less accumulated depreciation | (703) | (530) |
| | \$ 1,552 | \$ 350 |

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****5. Deferred Acquisition Costs**

Policy acquisition expenses, primarily consisting of commissions, premium taxes and underwriting expenses related to issuing a policy, incurred by NLASCO are deferred and charged against income ratably over the terms of the related policies. The activity in deferred acquisition costs for the nine months ended September 30, 2009 and 2008 is as follows (in thousands).

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2009 | 2008 |
| Beginning of period deferred acquisition cost | \$ 15,935 | \$ 14,521 |
| Acquisition expenses deferred | 23,311 | 23,859 |
| Amortization charged to income | (22,690) | (21,493) |
| End of period deferred acquisition costs | \$ 16,556 | \$ 16,887 |

6. Reserve for Unpaid Losses and Loss Adjustment Expenses

A roll-forward of the reserve for unpaid losses and loss adjustment expenses for the nine months ended September 30, 2009 and 2008 is as follows (in thousands).

| | Nine Months Ended September 30, | |
|-------------------------------|------------------------------------|------------|
| | 2009 | 2008 |
| Balance at January 1, | \$ 34,023 | \$ 18,091 |
| Less reinsurance recoverables | (14,613) | (2,692) |
| Net balance at January 1, | 19,410 | 15,399 |
| Incurred related to: | | |
| Current Year | 58,206 | 68,388 |
| Prior Year | (1,194) | 840 |
| Total incurred | 57,012 | 69,228 |
| Payments related to: | | |
| Current Year | (46,416) | (52,644) |
| Prior Year | (15,027) | (6,834) |
| Total payments | (61,443) | (59,478) |
| Net balance at September 30, | 14,979 | 25,149 |
| Plus reinsurance recoverables | 17,490 | 105,161 |
| Balance at September 30, | \$ 32,469 | \$ 130,310 |

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The reserve for losses and loss adjustment expenses includes amounts that may be due to the sellers of NLASCO by January 2010 based on actual losses incurred applicable to the reserve as of the acquisition date. Prior year losses and payments include amounts back to the purchase of NLASCO on January 31, 2007 only, as all other prior losses and payments are the responsibility of the sellers.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****6. Reserve for Unpaid Losses and Loss Adjustment Expenses (Continued)**

Incurred amounts related to prior years indicate that we were slightly redundant in incurred but not reported as of December 31, 2008, resulting in a benefit in the nine months ending September 30, 2009.

7. Reinsurance Activity

NLASCO attempts to limit the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risk. Substantial amounts of business are ceded; however, these reinsurance contracts do not relieve NLASCO from its obligations to policyholders. Such reinsurance includes quota share, excess of loss, catastrophe, and other forms of reinsurance on essentially all property and casualty lines of insurance. Net premiums earned, losses and loss adjustment expenses ("LAE") and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE and unearned premiums ceded to them are reported as assets. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE are reported as assets. Failure of reinsurers to honor their obligations could result in losses to NLASCO; consequently, allowances are established for amounts deemed uncollectible. NLASCO evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At September 30, 2009, we had reinsurance recoverables with no allowance of approximately \$19.2 million.

The effect of reinsurance on premiums written and earned for the three and nine months ended September 30, 2009 and 2008 is as follows (in thousands):

| | Three Months Ended | | | | Nine Months Ended | | | |
|-------------------------------|--------------------|-----------|--------------------|-----------|--------------------|-----------|--------------------|-----------|
| | September 30, 2009 | | September 30, 2008 | | September 30, 2009 | | September 30, 2008 | |
| | Written | Earned | Written | Earned | Written | Earned | Written | Earned |
| Premiums from direct business | \$ 30,593 | \$ 33,220 | \$ 31,430 | \$ 33,984 | \$ 96,876 | \$ 98,490 | \$ 98,725 | \$ 98,444 |
| Reinsurance assumed | 1,266 | 1,259 | 1,365 | 1,402 | 3,739 | 3,817 | 4,134 | 4,574 |
| Reinsurance ceded | (3,946) | (5,329) | (11,347) | (12,641) | (11,978) | (16,091) | (17,989) | (20,001) |
| Net premiums | \$ 27,913 | \$ 29,150 | \$ 21,448 | \$ 22,745 | \$ 88,637 | \$ 86,216 | \$ 84,870 | \$ 83,017 |

The effect of reinsurance incurred losses was as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2009 | September 30, 2008 | September 30, 2009 | September 30, 2008 |
| Loss and loss adjustment expense (LAE) incurred | \$ 22,102 | \$ 126,048 | \$ 71,745 | \$ 166,249 |
| Reinsurance recoverables | (7,051) | (96,102) | (14,733) | (97,021) |
| Net loss and LAE incurred | \$ 15,051 | \$ 29,946 | \$ 57,012 | \$ 69,228 |

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HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

7. Reinsurance Activity (Continued)

Multi-line excess of loss coverage

For all lines of business, retention on any one risk for 2009 is \$200,000.

Catastrophic coverage

As of September 30, 2009, NLASCO had five levels of catastrophic excess of loss reinsurance providing for coverage up to \$170.0 million through June 30, 2010 above \$1.0 million in retention for ASIC and \$6.0 million for NLIC. Total retention for any one catastrophe that affects both NLIC and ASIC is limited to \$6 million in the aggregate. NLASCO has an automatic reinstatement provision after the first loss for each layer to provide coverage in the event of subsequent catastrophes during the year. Coverage will lapse after the second or third event depending on the coverage layer, in which case NLASCO will evaluate the need for a new contract for the remainder of the year. During 2009, the first three layers can be reinstated once for 100%, 115% and 120% respectively, of the original premium each time and the next two layers can be reinstated one time for 100% of the original premium.

8. Income Taxes

At September 30, 2009, the Company had net operating loss carry-forwards for Federal income tax purposes, subject to certain limitations, of approximately \$45.3 million and \$49.1 million for regular income tax and alternative minimum tax, respectively. These net operating loss carry-forwards expire in 2018 through 2024. The utilization of the net operating losses is contingent upon the future earnings of the Company. If the future earnings of the Company are not realized there could be a valuation allowance for the net operating losses that are not utilized. The net operating loss carry-forwards for alternative minimum Federal income taxes generally are limited to offsetting 90% of the alternative minimum taxable earnings for a given period.

As of September 30, 2009, we had a deferred tax asset, net of liabilities, of \$12.0 million. Our 35% statutory rate is due to the expectation that future taxable income of our insurance business will primarily be subject to Federal but not state income taxes. Insurance companies are generally not taxed in most states on income, as they pay premium taxes in states where they generate premium revenue.

As a result of the allocation of the purchase price for the real estate assets we sold in 2007 by the purchaser, we reallocated \$34.1 million of gain recognized to those assets in the quarter ended September 30, 2008, the period in which the purchase price allocation was finalized. This reallocation allowed us to utilize \$34.1 million of our net operating loss carry forwards, which reduced our deferred tax asset by \$11.9 million and increased our income tax receivable by the same amount. In addition, we were able to utilize \$13.2 million of net operating losses that previously were limited under special IRS rules (the "Section 382 Limitations"), resulting in a deferred tax benefit of \$4.6 million.

GAAP requires the measurement of unrecognized tax benefits. Unrecognized tax benefits are the difference between a tax position taken, or expected to be taken, in a tax return and the benefit recognized for accounting purposes. For the three months ended September 30, 2009, we had no unrecognized tax benefits.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****8. Income Taxes (Continued)**

We file tax returns as prescribed by the tax laws of the jurisdictions in which we operate. We are subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitations expires. The following is a summary of the tax years open to examination:

U.S. Federal 2006 through 2008

U.S. States 2005 through 2008

As of September 30, 2009, the Company was not under audit for Federal income taxes, whereas there are two state income tax audits in process. The Company expects no material impact on its financials as a result of these state income tax audits.

The significant components of the provision for income taxes are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| Current tax benefit | \$ 2,734 | \$ 30,298 | \$ 2,746 | \$ 29,576 |
| Deferred tax (expense) benefit | (3,670) | (24,733) | 100 | (11,485) |
| Allowance | | 4,603 | | 4,603 |
| Income tax (expense) benefit | \$ (936) | \$ 10,168 | \$ 2,846 | \$ 22,694 |

The provision for income taxes differs from the amount that would be computed by applying the statutory Federal income tax rate of 35% to income before income taxes as a result of the following (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| Tax (expense) benefit at statutory rate | \$ (916) | \$ 5,541 | \$ 2,849 | \$ 18,083 |
| Permanent differences | (20) | 24 | (3) | 8 |
| Decrease in valuation allowance | | 4,603 | | 4,603 |
| Income (expense) tax benefit | \$ (936) | \$ 10,168 | \$ 2,846 | \$ 22,694 |

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****8. Income Taxes (Continued)**

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of significant temporary differences that give rise to the net deferred tax assets and liabilities are as follows (in thousands):

| | September 30, 2009 | December 31, 2008 |
|--|-----------------------|----------------------|
| Deferred Tax Assets: | | |
| Net operating loss carryforwards | \$ 15,850 | \$ 16,092 |
| Accrued liabilities and other | 2,270 | 1,890 |
| Loss and loss adjustment expense discounting | 356 | 477 |
| Securities available for sale | | 530 |
| Unearned premiums | 4,637 | 4,566 |
| Investments | 733 | 934 |
| Loan origination costs | 379 | 404 |
| Rental and other property, net | 36 | |
| AMT credit carryforward | 769 | 787 |
| Total gross deferred tax assets | \$ 25,030 | \$ 25,680 |
| Deferred Tax Liabilities: | | |
| Rental and other property, net | \$ | \$ 29 |
| Securities available for sale | 2,472 | |
| Intangible assets | 4,437 | 4,901 |
| Goodwill | 282 | 207 |
| Deferred policy acquisition costs | 5,794 | 5,577 |
| Total gross deferred tax liabilities | \$ 12,985 | \$ 10,714 |
| Net Deferred Tax Asset | \$ 12,045 | \$ 14,966 |

9. Statutory Net Income and Capital and Surplus

The Company's insurance subsidiaries, which are domiciled in the State of Texas, prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the Texas Department of Insurance, which Texas recognizes for determining solvency under Texas State Insurance Law. The Commissioner of the Texas Department of Insurance has the right to permit other practices that may deviate from prescribed practices. Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in Texas. Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future. The Company's insurance subsidiaries have no such permitted statutory accounting practices.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****9. Statutory Net Income and Capital and Surplus (Continued)**

The Company's insurance subsidiaries' statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the Texas Department of Insurance. Texas had adopted the National Association of Insurance Commissioners' (NAIC) statutory accounting practices as the basis of its statutory accounting practices with certain differences, which are not significant to the companies' statutory equity.

Following is a summary of statutory capital and surplus and statutory net income (loss) of each insurance subsidiary for the three and nine months ended September 30, 2009 and 2008 (in thousands).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|-------------------------------------|------------|------------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| National Lloyds Insurance Company | | | | |
| Capital and surplus | \$ 85,149 | \$ 79,019 | \$ 85,149 | \$ 79,019 |
| Statutory net (loss) income | \$ 3,447 | \$ (9,577) | \$ (955) | \$ (9,093) |
| American Summit Insurance Company | | | | |
| Capital and surplus | \$ 27,006 | \$ 23,862 | \$ 27,006 | \$ 23,862 |
| Statutory net (loss) income | \$ 1,615 | \$ (187) | \$ 2,689 | \$ 1,252 |

10. Capital and Dividend Restrictions

The funding of the cash requirements (including debt service) of NLASCO is primarily provided by cash dividends from NLASCO's wholly-owned insurance subsidiaries. Dividends paid by the insurance subsidiaries are restricted by regulatory requirements of the Texas Department of Insurance. Under Texas State Insurance Law for property and casualty companies, all dividends must be distributed out of earned surplus only. Furthermore, without the prior approval of the Commissioner, dividends cannot be declared or distributed which exceed the greater of ten percent of NLASCO's surplus, as shown by its last annual statement on file with the Commissioner, or 100% of net income for such period. The subsidiaries paid \$14.0 million in dividends to NLASCO in March 2008. At September 30, 2009, the maximum dividend that may be paid to NLASCO in 2009 without regulatory approval is approximately \$10.8 million. There have been no dividends paid in 2009.

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At September 30, 2009, the Company's insurance subsidiaries had statutory surplus in excess of the minimum required.

Also, the NAIC has adopted the risk based calculation ("RBC") formula for insurance companies that establishes minimum capital requirements relating to insurance risk, asset credit risk (RBC ratio), interest rate risk and business risk. The formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At September 30, 2009, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****SEPTEMBER 30, 2009****(unaudited)****11. Equity and Loss per share**

The following reflects the calculation of loss per share on a basic and diluted basis for the three and nine months ended September 30, 2009 and 2008 (in thousands, except per share information).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| Income (Loss) per share from operations: | | | | |
| Income (loss) from operations | \$ 1,683 | \$ (5,662) | \$ (5,292) | \$ (28,973) |
| Preferred stock dividends | (2,579) | (2,579) | (7,735) | (7,735) |
| Loss from operations after preferred dividends | \$ (896) | \$ (8,241) | \$ (13,027) | \$ (36,708) |
| Basic loss per share from operations | \$ (0.02) | \$ (0.15) | \$ (0.23) | \$ (0.65) |
| Diluted loss per share from operations | \$ (0.02) | \$ (0.15) | \$ (0.23) | \$ (0.65) |
| Loss per share available to common stockholders: | | | | |
| Loss available to common stockholders | \$ (896) | \$ (8,241) | \$ (13,027) | \$ (36,708) |
| Basic loss per share available to common stockholders | \$ (0.02) | \$ (0.15) | \$ (0.23) | \$ (0.65) |
| Diluted loss per share available to common stockholders | \$ (0.02) | \$ (0.15) | \$ (0.23) | \$ (0.65) |
| Weighted average share information: | | | | |
| Basic shares outstanding | 56,483 | 56,452 | 56,470 | 56,452 |

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| | | | | |
|--|--------|--------|--------|--------|
| Diluted shares outstanding | 56,483 | 56,452 | 56,470 | 56,452 |
| Weighted average equivalent shares excluded from diluted loss per share because they would be anti-dilutive: | | | | |
| Stock warrants | 1 | 1 | 1 | 1 |
| Senior exchangeable Notes | 6,718 | 6,718 | 6,718 | 6,718 |
| Stock options | 310 | 541 | 434 | 541 |
| Total | 7,029 | 7,260 | 7,153 | 7,260 |

In the quarter ending June 30, 2009, there were options exercised in cashless transactions resulting in 17,531 shares of common stock being issued and \$30 of cash being paid in lieu of fractional shares. For the quarter ended September 30, 2009, there were no options exercised.

On September 15, 2009, the board of directors declared a quarterly cash dividend of \$0.515625 per share on the Company's Series A Cumulative Redeemable Preferred Stock. The dividend was paid on October 30, 2009, to shareholders of record on October 15, 2009. The Board reviews the payment of dividends on a quarterly basis.

HILLTOP HOLDINGS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SEPTEMBER 30, 2009

(unaudited)

12. Commitments and Contingencies

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

We are a party to various legal actions resulting from our operating activities. These actions consist of litigation and administrative proceedings arising in the ordinary course of business, some of which are covered by liability insurance, and none of which is expected to have a material adverse effect on our consolidated financial condition, results of operations or cash flows taken as a whole.

13. Subsequent Events

Consistent with GAAP for subsequent events, Hilltop Holdings Inc. has evaluated subsequent events through November 6, 2009, the date of filing its report on Form 10-Q for the quarter ended September 30, 2009 with the SEC, and has no material subsequent events to report.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated historical financial statements and notes appearing elsewhere in this Quarterly Report on Form 10-Q and the financial information set forth in the tables below.

Unless the context otherwise indicates, all references in this Management's Discussion and Analysis and Financial Condition and Results for Operations, or MD&A, to the "Company", "Hilltop", "HTH", "we", "us", "our" or "ours" or similar words are to Hilltop Holdings Inc. (formerly known as Affordable Residential Communities Inc.) and its direct and indirect wholly-owned subsidiaries.

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this report that address results or developments that we expect or anticipate will or may occur in the future, that are preceded by, followed by or include the words "believes," "expects," "may," "will," "would," "could," "should," "seeks," "approximately," "intends," "plans," "projects," "estimates" or "anticipates" or the negative of these words and phrases or similar words or phrases, including such things as our business strategy, our financial condition, our litigation, our efforts to make strategic acquisitions, our liquidity and sources of funding, our capital expenditures, our products, market trends, operations and business, are forward-looking statements.

These forward-looking statements are based on our beliefs, assumptions and expectations of our future performance taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If an event occurs or further changes, our business, business plan, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Certain factors that could cause actual results to differ include, among others:

changes in the acquisition market;

our ability to find and complete strategic acquisitions with suitable merger or acquisition candidates or find other suitable ways in which to invest our capital;

the adverse impact of external factors, such as changes in interest rates, inflation and consumer confidence;

the condition of capital markets;

actual outcome of the resolution of any conflict;

our ability to use net operating loss carryforwards to reduce future tax payments;

the impact of the tax code and rules on our financial statements;

failure of NLASCO, Inc.'s insurance subsidiaries to maintain their respective A.M. Best ratings;

failure to maintain NLASCO, Inc.'s current agents;

lack of demand for insurance products;

cost or availability of adequate reinsurance;

changes in key management;

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severe catastrophic events in our geographic area;

failure of NLASCO, Inc.'s reinsurers to pay obligations under reinsurance contracts;

failure of NLASCO, Inc. to maintain sufficient reserves for losses on insurance policies;

failure to successfully implement NLASCO, Inc.'s new information technology system; and

failure of NLASCO, Inc. to maintain appropriate insurance licenses.

For a further discussion of these and other risks and uncertainties that could cause actual results to differ materially from those contained in our forward-looking statements, please refer to "Risk Factors" in Part I, Item 1A of our Annual Report on Form 10-K and 10-K/A, which was filed with the Securities and Exchange Commission on March 16, 2009 and April 2, 2009, respectively. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements and those risk factors, and there can be no assurance that the actual results or developments anticipated by us will be realized, or even substantially realized, and that they will have the expected consequences to, or effects on, us and our business or operations. Forward-looking statements made in this report speak as of the date of this report or as of the date specifically referenced in any such statement set forth in this report. We undertake no obligation to update or revise any forward-looking statements in this report.

GENERAL STRUCTURE OF THE COMPANY

We are a holding company that is endeavoring to make opportunistic acquisitions or a business combination. In connection with that strategy, we are identifying and evaluating potential targets on an ongoing basis. At September 30, 2009, Hilltop and its operating partnership, Affordable Residential Communities LP, had approximately \$742.2 million of available cash, cash equivalents and available for sale securities that could be used for this purpose. No assurances, however, can be given that we will be able to identify suitable targets, consummate acquisitions or a combination or, if consummated, successfully integrate or operate the acquired business.

Hilltop indirectly owns all of the outstanding shares of NLASCO, Inc., or NLASCO. NLASCO, in turn, owns National Lloyds Insurance Company, or NLIC, and American Summit Insurance Company, or ASIC, both of which are licensed property and casualty insurers operating in multiple states. In addition, NLASCO owns NALICO General Agency that operates in Texas. NLIC commenced business in 1949 and currently operates in 15 states with its largest market being the State of Texas. NLIC carries a financial strength rating of "A" (Excellent) by A.M. Best. ASIC was formed in 1955 and currently operates in 12 states, its largest market being the State of Arizona. ASIC carries a financial strength rating of "A-" (Excellent) by A.M. Best. Both of these companies are regulated by the Texas Department of Insurance.

Our common stock is listed on the New York Stock Exchange, or the NYSE, under the symbol "HTH". Our Series A Cumulative Redeemable Preferred Stock is listed on the NYSE under the symbol "HTH-PA".

OVERVIEW OF RESULTS

For the nine months ended September 30, 2009, net loss attributable to common stockholders was \$13.0 million, or \$0.23 per share, as compared to net loss of \$36.7 million, or \$0.65 per share, for the same period in 2008. Net loss from operations accounted for \$5.3 million of the net loss for the nine months ended September 30, 2009, compared to \$29.0 million of the net loss for the nine months ended September 30, 2008.

The \$23.7 million decrease in net loss from operations for the nine months ended September 30, 2009, as compared to the same period in 2008, is primarily due to the loss on investments decreasing

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by \$42.2 million (\$27.4 million net of tax). This decrease primarily relates to a \$41.9 million loss on securities sold (\$27.2 million net of tax) during the nine months ended September 30, 2009, for equity securities held at HTH for potential acquisition. The decrease in loss on investments for the nine months ended September 30, 2009 due to lower investment income in 2009 of \$16.9 million (\$11.0 million net of tax) primarily generated on the cash at HTH, a decrease in loss and loss adjustment expense of \$12.2 million (\$7.9 million net of tax), and an increase in earned premium of \$3.2 million (\$2.1 million net of tax) due to lower reinstatement premiums offset by higher reinsurance costs.

BUSINESS OBJECTIVES AND OPERATING STRATEGIES

Strategic Acquisitions. Hilltop is seeking to make opportunistic acquisitions with its cash and, if necessary or appropriate, from additional equity or debt financing sources.

Insurance Operations. NLASCO specializes in providing fire and homeowners insurance for low value dwellings and manufactured homes, primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer service and responding quickly to the needs of its agents and policyholders. NLASCO applies a high level of selectivity in the risks it underwrites and uses a risk-adjusted return approach to capital allocation, which NLASCO believes allows it to consistently generate underwriting profits.

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. A.M. Best assigned NLIC a financial strength rating of "A" (Excellent) and ASIC a rating of "A-" (Excellent). An "A" rating is the third highest of 15 rating categories used by A.M. Best, and an "A-" rating is the fourth highest of 15 rating categories. In evaluating a company's financial and operating performance, A.M. Best reviews a company's profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its liabilities for losses and loss adjustment expenses, or LAE, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. This rating is intended to provide an independent opinion of an insurer's ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best's expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and LAE, and is subject to revocation or revision at any time at the sole discretion of A.M. Best. NLASCO cannot ensure that NLIC and ASIC will maintain their present ratings.

Critical Accounting Policies and Estimates

The Company has prepared its unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, or GAAP, which require certain estimates and assumptions that affect the recorded amount of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP, however, have been condensed or omitted pursuant to Article 10 of Regulation S-X. A summary of HTH's significant accounting policies has been provided in its Form 10-K and 10-K/A for the year ended December 31, 2008. Summarized below are those accounting policies that require the most difficult, subjective or

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complex judgments and that have the most significant impact on HTH's financial condition and results of operations. Management evaluates these estimates on an ongoing basis. These estimates are based on information currently available to management and on various other assumptions management believes are reasonable.

Losses and Loss Adjustment Expenses. The liability for losses and loss adjustment expenses represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims that have not yet been reported. The amount of loss reserves for reported claims is based primarily on a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amounts of loss reserves for unreported claims and loss adjustment expenses are determined using historical information as adjusted to current conditions.

When a claim is reported, a "case reserve" is established for the estimated amount of the ultimate payment. This estimate reflects an informed judgment based upon general insurance reserving practices and the experience and knowledge of the Company. The estimate considers the nature and value of the specific claim, the severity of injury or damage, and the policy provisions relating to the type of loss. Case reserves are adjusted as more information becomes available.

We maintain incurred but not reported, or IBNR, reserves to provide for already incurred claims that have not yet been reported and developments on reported claims. The IBNR reserve is estimated based on the volume of premiums written and is reviewed quarterly by our actuaries.

Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in earnings currently. The liability for losses and loss adjustment expenses has not been reduced for reinsurance recoverables.

Investment Securities. Investment securities consist of U.S. Government, mortgage-backed, corporate debt and equity securities. We classify our fixed maturities in one of three categories: trading, available-for-sale or held-to-maturity; and our equity securities are classified as trading or available-for-sale. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity debt securities are those securities in which we have the ability and intent to hold the security until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in earnings. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of trading and available-for-sale securities are determined on a specific identification basis.

We regularly review our investment securities to assess whether the security is impaired and if impairment is other-than-temporary. A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether impairment is other-than-temporary, we consider whether we are more likely than not to hold an investment until a market price recovery and consider whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and

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duration of the impairment, changes in value subsequent to period end, and forecasted performance of the investee.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

Deferred Acquisition Costs. Costs of acquiring insurance vary with, and are primarily related to, the production of new and renewal business and principally consist of commissions, premium taxes and underwriting expenses. These costs are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Proceeds from reinsurance transactions that represent recovery of acquisition costs reduce applicable unamortized acquisition costs in a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. Future investment income is considered in determining the recoverability of deferred acquisition costs. The Company regularly reviews the categories of acquisition costs that are deferred and assesses the recoverability of this asset. A premium deficiency, and a corresponding charge to income, is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs and maintenance costs exceeds related unearned premiums and anticipated investment income. At September 30, 2009, there was no premium deficiency.

Revenue Recognition. Property and liability premiums are recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums. We routinely evaluate the premium receivable balance to determine if an allowance for uncollectible accounts is necessary.

Other income consists of premium installment charges, which are recognized when earned, and other miscellaneous income.

Reinsurance. In the normal course of business, NLASCO seeks to reduce losses that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Net premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE are reported as assets. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy.

The Company accounts for reinsurance contracts under the provisions of GAAP in accounting and reporting for reinsurance. Net premiums earned, losses and LAE, and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE and unearned premiums ceded to them are reported as assets. Reinsurance assumed from other companies, including assumed premiums written and earned and losses and LAE, is accounted for in the same manner as direct insurance written.

Income Taxes. The Company accounts for income tax in accordance with GAAP, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. GAAP also requires that we determine whether the benefits of our tax positions are more likely than not of being sustained upon audit based on the technical merits of the tax position. For tax positions that are more likely than not of being sustained upon audit, we recognize the largest amount of the benefit that is more likely than not of being sustained in our consolidated financial statements. For tax positions that are not likely of being sustained upon audit, we do not recognize any portion of the benefits in our consolidated financial statements. The provisions of GAAP also provide guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure.

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Goodwill and Other Indefinite Lived Intangible Assets. Goodwill for HTH represents the excess of the cost over fair value of assets of NLASCO. Goodwill is tested annually for impairment and is tested more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value.

The goodwill impairment analysis is a two-step test. The first step ("Step 1"), used to identify potential impairment, involves comparing each reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of a reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. The Company has estimated fair values of reporting units based on a market approach using historic, normalized actual and forecast results.

The second step ("Step 2") involves calculating an implied fair value of goodwill for each reporting unit for which the first step indicated impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. An impairment loss cannot exceed the carrying value of goodwill assigned to a reporting unit, and the loss establishes a new basis in the goodwill. Subsequent reversal of goodwill impairment losses is not permitted.

Fair Value. The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in GAAP for fair value measurements. The framework is based on the inputs used in valuation and requires that observable inputs be used in the valuations when available. In the disclosure of fair value estimates in GAAP, the hierarchy is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows: Level 1 Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access. Level 2 Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data. Level 3 Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use.

RESULTS OF OPERATIONS

Comparison of the Three Months Ended September 30, 2009 to the Three Months Ended September 30, 2008

Revenue. Revenue for the three months ended September 30, 2009 was \$32.7 million, as compared to \$29.7 million for the same period in 2008. Net premiums earned were \$29.1 million for the three months ended September 30, 2009, as compared to \$22.7 million for 2008. Net premiums earned were favorable by \$6.4 million due to the reinstatement premium booked in 2008 of \$8.2 million for hurricanes Dolly, Gustav and Ike offset by higher reinsurance costs and direct premiums earned in 2009. Net investment income was \$1.5 million for the three months ended September 2009, as compared to \$6.7 million for the same period in 2008, primarily due to lower yields on HTH parent only cash of \$4.7 million. We had a net realized gain on investments of \$0.2 million in for the three

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months ended September 30, 2009, as compared to a net loss of \$1.1 million, due to an other-than-temporary impairment of \$1.1 million for the same period in 2008. Other income was \$1.9 million for the third quarter in 2009, as compared to \$1.5 million for 2008. The increase in service fee income was primarily due to additional fees for policies that include wind coverage in hurricane prone areas. Net income before preferred stock dividends for the three months ended September 30, 2009, was \$1.7 million due to the profitability of the insurance operations at NLASCO partially offset by losses from the parent, HTH.

Underwriting Results. The following table shows the components of the Company's underwriting gain (loss) for the three months ended September 30, 2009 and 2008. The Company's underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. The underwriting results are discussed below (in thousands).

| | Three Months Ended September 30, | | | |
|---|---|-------------|---------------|-----------------|
| | 2009 | 2008 | Change | % Change |
| Direct premiums written | \$ 30,593 | \$ 31,430 | \$ (837) | -2.7% |
| Net premiums written | \$ 27,913 | \$ 21,448 | \$ 6,465 | 30.1% |
| Net premiums earned | \$ 29,150 | \$ 22,745 | \$ 6,405 | 28.2% |
| Loss and LAE | 15,051 | 29,946 | (14,895) | -49.7% |
| Policy acquisition and other underwriting expenses | 10,333 | 10,736 | (403) | -3.8% |
| Underwriting gain (loss) | \$ 3,766 | \$ (17,937) | \$ 21,703 | -121.0% |
| Agency expenses | \$ (518) | \$ (581) | \$ 63 | -10.8% |
| Loss and LAE ratio | 51.6% | 131.7% | -80.1% | |
| Policy acquisition and other underwriting expense less agency expense ratio | 33.7% | 44.6% | -10.9% | |
| Combined ratio | 85.3% | 176.3% | -91.0% | |

The Company seeks to operate at a combined ratio of no greater than 85.0%. Loss ratios are ratios that express the relationship of losses to premiums. The loss and LAE ratio is loss and LAE expenses divided by net premiums earned for the same period. The policy acquisition and other underwriting expense ratio is policy acquisition and other underwriting expense, divided by net premiums earned for the same period. Combined ratio is the sum of both previous ratios.

Premiums. The property and casualty insurance industry is affected by soft and hard market business cycles. During a soft market, price competition tends to increase as insurers are willing to reduce premium rates in order to maintain growth in premium volume. The soft market makes it more difficult to attract new business, as well as retain exposures which are adequately priced. Although we recognize the need to remain competitive in the marketplace, the Company remains committed to its disciplined underwriting philosophy accepting only risks that are appropriately priced, while declining risks which are under priced for the level of coverage provided.

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Direct premiums written by major product line for the three months ended September 30, 2009 and 2008, are presented in the table below (in thousands):

| | Three Months Ended September 30, | | | |
|---------------------------------|-------------------------------------|------------------|-----------------|--------------|
| | 2009 | 2008 | Change | % Change |
| Direct Premiums Written: | | | | |
| Homeowners | \$ 12,579 | \$ 13,203 | \$ (624) | -4.7% |
| Fire | 11,541 | 12,059 | (518) | -4.3% |
| Mobile Home | 4,613 | 4,498 | 115 | 2.6% |
| Commercial | 1,724 | 1,533 | 191 | 12.5% |
| Other | 136 | 137 | (1) | -0.7% |
| | \$ 30,593 | \$ 31,430 | \$ (837) | -2.7% |

Total direct premiums written decreased for the three months ended September 30, 2009 for all of the insurance products, except mobile home and commercial lines. The decrease was due to stronger competition and more challenging economic times.

Net premiums written by major product line for the three months ended September 30, 2009 and 2008, are presented in the table below (in thousands):

| | Three Months Ended September 30, | | | |
|-----------------------------|-------------------------------------|------------------|-----------------|--------------|
| | 2009 | 2008 | Change | % Change |
| Net Premiums Written | | | | |
| Homeowners | \$ 11,477 | \$ 9,010 | \$ 2,467 | 27.4% |
| Fire | 10,530 | 8,229 | 2,301 | 28.0% |
| Mobile Home | 4,209 | 3,069 | 1,140 | 37.1% |
| Commercial | 1,573 | 1,046 | 527 | 50.4% |
| Other | 124 | 94 | 30 | 31.9% |
| | \$ 27,913 | \$ 21,448 | \$ 6,465 | 30.1% |

Total net premiums written increased for the three months ended September 30, 2009 for all insurance products due to reinstatement premiums related to hurricanes Dolly, Gustav and Ike of \$8.2 million in 2008, partially offset by higher reinsurance costs and lower direct premiums in 2009.

Net premiums earned by major product line for the three months ended September 30, 2009 and 2008, are presented in the table below (in thousands):

| | Three Months Ended September 30, | | | |
|-----------------------------|-------------------------------------|------------------|-----------------|--------------|
| | 2009 | 2008 | Change | % Change |
| Net Premiums Earned: | | | | |
| Homeowners | \$ 11,984 | \$ 9,555 | \$ 2,429 | 25.4% |
| Fire | 10,997 | 8,727 | 2,270 | 26.0% |
| Mobile Home | 4,396 | 3,255 | 1,141 | 35.1% |
| Commercial | 1,643 | 1,109 | 534 | 48.2% |
| Other | 130 | 99 | 31 | 31.3% |
| | \$ 29,150 | \$ 22,745 | \$ 6,405 | 28.2% |

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Net premiums earned for the three months ended September 30, 2009 increased for all products due to the reinstatement premiums related to hurricanes Dolly, Gustav and Ike of \$8.2 million in 2008, partially offset by higher reinsurance costs and lower direct premiums in 2009.

Policy Acquisition and Other Underwriting Expenses. Policy acquisition and other underwriting expenses for the three months ended September 30, 2009 and 2008 were as follows (in thousands):

| | Three Months Ended September 30, | | | |
|---|-------------------------------------|------------------|-----------------|--------------|
| | 2009 | 2008 | Change | % Change |
| Amortization of deferred policy acquisition costs | \$ 7,718 | \$ 7,875 | \$ (157) | -2.0% |
| Other underwriting expenses | 2,615 | 2,861 | (246) | -8.6% |
| Total policy acquisition and other underwriting expenses | 10,333 | 10,736 | (403) | -3.8% |
| Agency expenses | (518) | (581) | 63 | -10.8% |
| Total policy acquisition and other underwriting expenses excluding agency expenses | \$ 9,815 | \$ 10,155 | \$ (340) | -3.3% |
| Net premiums earned | \$ 29,150 | \$ 22,745 | \$ 6,405 | 28.2% |
| Expense ratio | 33.7% | 44.6% | -10.9% | |

Total policy acquisition and other underwriting expenses are down \$0.4 million due to the decrease in the amortization of deferred policy acquisition costs and other underwriting expenses.

Loss and Loss Adjustment Expenses. Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. The loss and LAE ratio is calculated by taking the ratio of incurred losses and LAE to net premiums earned. The loss and LAE ratio for the three months ended September 30, 2009 and 2008 of 51.6% and 131.7%, respectively, has been adjusted to remove the effect of losses attributable to the prior owner. The non cat loss and LAE ratios for the three months ended September 30, 2009 and 2008 were 51.3% and 54.8%, respectively. The decrease in the loss and LAE ratio is due to several hurricanes that occurred in July and September 2008. The actual loss related to Hurricane Dolly, Gustav and Ike excluding reinstatement premium is \$13.0 million.

General and Administrative Expense. General and administrative expense for the three months ended September 30, 2009 was \$1.7 million, largely unchanged, as compared to \$1.8 million for the three months ended September 30, 2008.

Depreciation and Amortization Expense. Depreciation and amortization expense for the three months ended September 30, 2009 and 2008 was \$0.5 million.

Interest Expense. Interest expense for the three months ended September 30, 2009 was \$2.5 million, as compared to \$2.6 million for the three months ended September 30, 2008, a decrease of \$0.1 million, or 4.0%. The small decrease is due to lower rates on our variable rate debt.

Income Taxes. The Company had a \$0.9 million income tax expense for the three months ended September 30, 2009, compared to \$10.2 million benefit for the same period in 2008. The expense in 2009 is primarily due to the tax expense recorded as a result of operating income of NLASCO of \$2.6 million. The benefit in 2008 is primarily due to the tax benefit recorded as a result of operating losses of NLASCO and recognizing losses on the impairment of \$0.4 million of investment securities.

Preferred Stock Dividend. On September 15, 2009, the HTH board of directors declared a quarterly cash dividend of \$0.5156 per share on each of the 5,000,000 outstanding shares of our

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Series A Preferred Stock, payable October 30, 2009, amounting to \$2.6 million. For the quarter ended September 30, 2008, the dividend declared also was \$0.5156 per share, or \$2.6 million.

Net Loss Attributable to Common Stockholders. As a result of the foregoing, our net loss attributable to common stockholders was \$0.9 million for the three months ended September 30, 2009, as compared to net loss of \$8.2 million for the three months ended September 30, 2008. The principal reason for the loss in the third quarter of 2009 is due to lower direct premiums written and lower interest income generated on the cash balances at HTH, due to lower interest rates in 2009.

Comparison of the Nine Months Ended September 30, 2009 to the Nine Months Ended September 30, 2008

Revenue. Revenue for the nine months ended September 30, 2009 was \$95.7 million, as compared to \$66.7 million for the same period in 2008. Net premiums earned were \$86.2 million for the first nine months in 2009, as compared to \$83.0 million for 2008. Net investment income was \$4.9 million for the first nine months of 2009, as compared to \$21.9 million for the same period in 2008. The \$17.0 million unfavorable investment income was primarily due to lower investment yields on the HTH parent only cash of \$15.7 million. We had a net realized loss on investments of \$0.6 million in the first nine months of 2009, due to the write down and subsequent sale of securities primarily owned by NLASCO, as compared to \$42.9 million for the same period in 2008, which related to equity securities held by HTH for a potential acquisition. Other income was \$5.1 million for the first nine months in 2008, as compared to \$4.7 million for 2008.

Underwriting Results. The following table shows the components of the Company's underwriting loss for the nine months ended September 30, 2009 and 2008. The Company's underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. The underwriting results are discussed below (in thousands).

| | Nine Months Ended September 30, | | Change | % Change |
|---|------------------------------------|-------------|------------|----------|
| | 2009 | 2008 | | |
| Direct premiums written | \$ 96,876 | \$ 98,725 | \$ (1,849) | -1.9% |
| Net premiums written | \$ 88,637 | \$ 84,870 | \$ 3,767 | 4.4% |
| Net premiums earned | \$ 86,216 | \$ 83,017 | \$ 3,199 | 3.9% |
| Loss and LAE | 57,012 | 69,228 | (12,216) | -17.6% |
| Policy acquisition and other underwriting expenses | 32,616 | 32,350 | 266 | 0.8% |
| Underwriting loss | \$ (3,412) | \$ (18,561) | \$ 15,149 | -81.6% |
| Agency expenses | \$ (1,569) | \$ (1,821) | \$ 252 | -13.8% |
| Loss and LAE ratio | 66.1% | 83.4% | -17.3% | |
| Policy acquisition and other underwriting expense less agency expense ratio | 36.0% | 36.8% | -0.8% | |
| Combined ratio | 102.1% | 120.2% | -18.1% | |

The Company seeks to operate at a combined ratio of no greater than 85.0%; however, due to increase in frequency and severity of wind, hail and fire losses during the nine months ended September 30, 2009 and 2008, our combined ratio was 102.1% and 120.2%, respectively. Loss ratios are ratios that express the relationship of losses to premiums. The loss and LAE ratio is loss and LAE divided by net premiums earned for the same period. The policy acquisition and other underwriting expense ratio is policy acquisition and other underwriting expense less agency expenses, divided by net premiums earned for the same period. Combined ratio gives you the sum of both previous ratios.

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Premiums. The property and casualty insurance industry is affected by soft and hard market business cycles. During a soft market, price competition tends to increase as insurers are willing to reduce premium rates in order to maintain growth in premium volume. The soft market makes it more difficult to attract new business, as well as retain exposures which are adequately priced. Although we recognize the need to remain competitive in the marketplace, the Company remains committed to its disciplined underwriting philosophy accepting only risks that are appropriately priced, while declining risks which are under priced for the level of coverage provided.

Direct premiums written by major product line for the nine months ended September 30, 2009 and 2008, are presented in the table below (in thousands):

| | Nine Months Ended September 30, | | | |
|---------------------------------|------------------------------------|------------------|-------------------|--------------|
| | 2009 | 2008 | Change | % Change |
| Direct Premiums Written: | | | | |
| Homeowners | \$ 39,562 | \$ 41,537 | \$ (1,975) | -4.8% |
| Fire | 36,717 | 37,429 | (712) | -1.9% |
| Mobile Home | 15,514 | 14,851 | 663 | 4.5% |
| Commercial | 4,748 | 4,562 | 186 | 4.1% |
| Other | 335 | 346 | (11) | -3.2% |
| | \$ 96,876 | \$ 98,725 | \$ (1,849) | -1.9% |

Total direct premiums written decreased for the nine months ended September 30, 2009 for all of the insurance products, except mobile home and commercial, as a result of stronger competition and more challenging economic times.

Net premiums written by major product line for the nine months ended September 30, 2009 and 2008, are presented in the table below (in thousands):

| | Nine Months Ended September 30, | | | |
|-----------------------------|------------------------------------|------------------|-----------------|-------------|
| | 2009 | 2008 | Change | % Change |
| Net Premiums Written | | | | |
| Homeowners | \$ 36,197 | \$ 35,708 | \$ 489 | 1.4% |
| Fire | 33,594 | 32,176 | 1,418 | 4.4% |
| Mobile Home | 14,195 | 12,766 | 1,429 | 11.2% |
| Commercial | 4,344 | 3,921 | 423 | 10.8% |
| Other | 307 | 299 | 8 | 2.7% |
| | \$ 88,637 | \$ 84,870 | \$ 3,767 | 4.4% |

Total net premiums written increased for the nine months ended September 30, 2009 for all lines of business due to reinstatement premiums related to hurricanes Dolly, Gustav and Ike of \$8.2 million in 2008, partially offset by higher reinsurance costs and lower direct premiums in 2009.

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Net premiums earned by major product line for the nine months ended September 30, 2009 and 2008, are presented in the table below (in thousands):

| | Nine Months Ended September 30, | | Change | % Change |
|-----------------------------|------------------------------------|------------------|-----------------|-------------|
| | 2009 | 2008 | | |
| Net Premiums Earned: | | | | |
| Homeowners | \$ 35,208 | \$ 34,929 | \$ 279 | 0.8% |
| Fire | 32,677 | 31,474 | 1,203 | 3.8% |
| Mobile Home | 13,807 | 12,488 | 1,319 | 10.6% |
| Commercial | 4,225 | 3,836 | 389 | 10.1% |
| Other | 299 | 290 | 9 | 3.1% |
| | \$ 86,216 | \$ 83,017 | \$ 3,199 | 3.9% |

Net premiums earned for the nine months ended September 30, 2009 were up as compared to 2008 due to the reinstatement premium related to hurricanes Dolly, Gustav and Ike of \$8.2 million in 2008, partially offset by higher reinsurance costs and lower direct premiums written in 2009.

Policy Acquisition and Other Underwriting Expenses. Policy acquisition and other underwriting expenses for the nine months ended September 30, 2009 and 2008 were as follows (in thousands):

| | Nine Months Ended September 30, | | Change | % Change |
|--|------------------------------------|-----------|----------|----------|
| | 2009 | 2008 | | |
| Amortization of deferred policy acquisition costs | \$ 22,690 | \$ 21,493 | \$ 1,197 | 5.6% |
| Other underwriting expenses | 9,926 | 10,857 | (931) | -8.6% |
| Total policy acquisition and other underwriting expenses | 32,616 | 32,350 | 266 | 0.8% |
| Agency expenses | (1,569) | (1,821) | 252 | -13.8% |
| Total policy acquisition and other underwriting expenses excluding agency expenses | \$ 31,047 | \$ 30,529 | \$ 518 | 1.7% |
| Net premiums earned | \$ 86,216 | \$ 83,017 | \$ 3,199 | 3.9% |
| Expense ratio | 36.0% | 36.8% | -0.8% | |

Total policy acquisition and other underwriting expenses are up \$0.5 million due to the increase in amortization of deferred policy acquisition costs of \$1.2 million and a decrease in other underwriting expenses of \$0.9 million.

Loss and Loss Adjustment Expenses. Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. The loss and LAE ratio is calculated by taking the ratio of incurred losses and LAE to net premiums earned. The loss and LAE ratio for the nine months ended September 30, 2009 and 2008 of 66.1% and 83.4%, respectively, has been adjusted to remove the effect of losses attributable to the prior owner. The decrease in the loss and LAE ratio is due to several severe spring storms and several hurricanes that occurred in July and September 2008. The actual loss related to Hurricane Dolly, Gustav and Ike, excluding reinstatement premium, was \$13.0 million.

General and Administrative Expense. General and administrative expense for the nine months ended September 30, 2009 was \$5.3 million, as compared to \$7.2 million for the nine months ended September 30, 2008, a decrease of \$1.9 million, or 26%. This decrease was mainly due to a decrease in business acquisition cost of \$1.4 million. The acquisition costs related to expenses incurred in

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connection with a possible transaction, that, as of the second quarter of 2008, we determined no longer to pursue.

Depreciation and Amortization Expense. Depreciation and amortization expense was \$1.5 million for the nine months ended September 30, 2009, largely unchanged as compared to \$1.6 million in 2008.

Interest Expense. Interest expense for the nine months ended September 30, 2009 was \$7.4 million, as compared to \$7.9 million for the nine months ended September 30, 2008, a decrease of \$0.5 million, or 7.0%. The decrease in interest expense is due to the pay down of debt in the first quarter of 2008 and lower rates on variable rate debt in 2009.

Income Taxes. The Company had a \$2.8 million income tax benefit for the nine months ended September 30, 2009, compared to a \$22.7 million benefit for the same period in 2008, of which \$4.6 million related to the reduction of the valuation allowance in 2008. The benefit in 2009 is primarily due to the tax benefit recorded as a result of the operating losses of HTH parent only offset by operating profits of NLASCO.

Preferred Stock Dividend. On March 11, 2009, the HTH board of directors declared quarterly cash dividends of \$0.5156 per share on each of the 5,000,000 outstanding shares of our Series A Preferred Stock, payable April 30, 2009, amounting to \$2.6 million. On June 11, 2009, the HTH board of directors declared quarterly cash dividends of 0.5156 per share on each of the 5,000,000 outstanding shares of our Series A Preferred Stock, payable July 30, 2009, amounting to \$2.6 million. On September 15, 2009, the HTH board of directors declared a quarterly cash dividend of \$0.5156 per share on each of the 5,000,000 outstanding shares of our Series A Preferred Stock, payable October 30, 2009, amounting to \$2.6 million. For the nine months ended September 30, 2009, the dividends declared were \$1.5468 per share, or \$7.7 million.

Net Loss Attributable to Common Stockholders. As a result of the foregoing, our net loss attributable to common stockholders was \$13.0 million for the nine months ended September 30, 2009, as compared to \$36.7 million of net loss for the nine months ended September 30, 2008. The principal reason for the loss in the first nine months of 2009 is due to lower direct premiums written and lower interest income generated on cash balances at HTH, due to lower interest rates in 2009.

LIQUIDITY AND CAPITAL RESOURCES

General

Hilltop is a holding company whose assets primarily consist of the stock of its subsidiaries and invested assets with a combined value of \$1,041 million at September 30, 2009. At September 30, 2009, the Company had invested approximately \$492.2 million in overnight deposits at JP Morgan Chase, Bank of America, and Wells Fargo. These investments are guaranteed under the Temporary Liquidity Guarantee Program.

Hilltop is seeking to make opportunistic acquisitions with its available cash and, if necessary or appropriate, from additional equity or debt financing sources.

At September 30, 2009, we had approximately \$527.8 million of cash and cash equivalents and \$391.8 million of investments, as compared to \$749.4 million of cash and cash equivalents and \$138.6 million of investments as of December 31, 2008. HTH moved its cash from interest bearing to non interest bearing accounts in January 2009 in order to reduce its risk of principal loss under the Temporary Liquidity Guarantee Program. In June 2009, HTH moved its cash from non interest bearing accounts to short term U.S. Treasuries to earn as much yield as possible while preserving liquidity and protecting against any loss of principle.

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As of September 30, 2009, our short-term liquidity needs included (a) funds for dividend payments on our \$125 million Series A cumulative redeemable preferred stock bearing a dividend rate of 8.25% per annum (approximately \$10.3 million annually), (b) funds to pay our insurance claims and (c) funds to service our debt.

Restrictions on Dividends and Distributions

Aside from investment income on Hilltop's invested assets, as a holding company, Hilltop relies on dividends and other permitted distributions from its subsidiaries. The payment of dividends from Hilltop's insurance subsidiaries, NLIC and ASIC, are subject to significant limitations under debt agreements, which limit their ability to declare and pay dividends in the event of a default.

Additionally, under Texas State Insurance Law for property and casualty companies, all dividends must be distributed out of earned surplus only. Furthermore, without the prior approval of the Commissioner and Texas Department of Insurance, dividends cannot be declared or distributed that exceed the greater of ten percent of the company's surplus, as shown by its last annual statement on file with the Commissioner, or 100% of net income for such period. NLIC and ASIC paid dividends totaling \$14.0 million to NLASCO in March 2008. At September 30, 2009, the maximum additional dividends that may be paid to NLASCO in 2009 without regulatory approval is approximately \$10.8 million.

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At September 30, 2009, the Company's insurance subsidiaries had statutory surplus in excess of the minimum required.

Also, the National Association of Insurance Commissioners, or NAIC, has adopted risk-based capital, or "RBC", requirements for insurance companies that establish minimum capital requirements relating to insurance risk, assesses credit risk, interest rate risk and business risk. The formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At September 30, 2009, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required.

We believe that restrictions on the payments of dividends by our subsidiary companies will not have a material impact on our ability to carry out our normal business activities, including dividend payments on our Series A cumulative redeemable preferred stock and debt payments on our senior exchangeable notes.

Sources and Uses of Funds

Our primary investment objective is to preserve capital. Our strategy is to purchase securities in sectors that represent the most attractive relative value. Bonds, cash and short-term investments constitute \$910.8 million, or 99.0%, of our investments at September 30, 2009. There is no intent to dispose of these investments at this time, other than those securities with previously taken other-than-temporary impairment in which the Company intends to sell the securities before maturity. Our bonds are substantially in readily marketable securities.

Our investment committee meets regularly to review the portfolio performance and investment markets in general. Our management generally meets monthly to review the performance of investments and monitor market conditions for investments that would warrant any revision to investment guidelines.

Cash provided by operations was \$14.8 million for the nine months ended September 30, 2009, primarily due to the decrease in income tax receivable of \$22.0 million offset by the net loss of \$5.3 million and the \$7.3 million change in operating assets and liabilities. Cash used in operations was

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\$3.4 million for the nine months ended September 30, 2008, due to the payment of \$10.1 million in state income taxes.

Cash used in investing activities was \$228.7 million in the nine months ended September 30, 2009, compared with cash used in investing activities of \$17.2 million in the same period in 2008. The cash used in investing activities for the nine months ended September 30, 2009 is primarily due to the net purchases of \$250.0 million of available for sale securities at HTH in September 2009. Cash used in investing activities for the nine months ended September 30, 2008 was due to the designation of \$18.5 million as restricted cash.

Cash used in financing activities was \$7.7 million for the nine months ended September 30, 2009, compared with cash used in financing activities of \$11.7 million in the same period in 2008. The decrease in cash used in financing activities was due primarily to the repayment of \$4.0 million in debt in 2008.

We believe that existing cash and investment balances, when combined with anticipated cash flows from operations and dividends from our insurance companies, will be adequate to meet our expected liquidity needs for the reasonably foreseeable future. We will continue to pursue and investigate possible strategic investments. In regards to strategic acquisitions, we may need to secure external financing. We cannot assure you that we will be successful in obtaining any such financing or in the implementation of our business plan.

Inflation

Inflation in the U.S. has been relatively low in recent years and did not have a material impact on our results of operations for the nine months ended September 30, 2009 and 2008. Although the impact of inflation has been relatively insignificant in recent years, it remains a factor in the United States economy and may increase the cost of acquiring or replacing property and equipment and the costs of labor and utilities.

COMMITMENTS

NLASCO's loss reserves do not have contractual maturity dates. However, based on historical payment patterns, the following table estimates when management expects the loss reserves to be paid. The timing of claim payments is subject to significant uncertainty. NLASCO maintains a portfolio of investments with varying maturities to provide adequate cash flows for the payment of claims.

| | Reserves (in thousands) |
|------------|--|
| 2009 | \$ 9,643 |
| 2010 | 13,767 |
| 2011 | 4,481 |
| 2012 | 2,240 |
| 2013 | 974 |
| Thereafter | 1,364 |
| | \$ 32,469 |

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our future income, cash flows and fair values relevant to financial instruments are dependent upon market interest rates. Market risk relates to the risk of loss from adverse changes in market prices and interest rates. We may use some derivative financial instruments to manage, or hedge, interest rate risks related to our borrowings from time to time. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors. As of nine months ended September 30, 2009, we had no derivative financial instruments.

As of September 30, 2009, our total debt outstanding was approximately \$138.4 million, comprised of approximately \$90.9 million, or 65.7%, of indebtedness subject to fixed interest rates and approximately \$47.5 million, or 34.3% of our total consolidated debt, subject to variable interest rates.

If LIBOR and the prime rate were to increase by one eighth of one percent (0.125%), the increase in interest expense on the variable rate debt would decrease future earnings and cash flows by approximately \$59,000 annually.

Interest risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of any change in overall economic activity that could occur in that environment. Further, in the event of a change of that magnitude, we may take actions to further mitigate our exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.

The fair value of debt outstanding as of September 30, 2009 was approximately \$148.2 million.

The following table sets forth certain information with respect to our indebtedness outstanding as of September 30, 2009 (in thousands).

| | Principal Commitments | | |
|---------------------|-----------------------|-----------|------------|
| | Fixed | Variable | Total |
| 2009 | \$ | \$ 18 | \$ 18 |
| 2013 and Thereafter | 90,850 | 47,500 | 138,350 |
| Commitments | \$ 90,850 | \$ 47,518 | \$ 138,368 |

ITEM 4. CONTROLS AND PROCEDURES

a) Disclosure Controls and Procedures. The Company's management, with the supervision and participation of the Company's Chief Executive Officer and Chief Accounting Officer, has evaluated the effectiveness of the design and operation of Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Accounting Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 and are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Accounting Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in internal control over financial reporting. There have not been any changes in our internal control over financial reporting (as defined in Rule 13a-15(f) promulgated under the Securities

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Exchange Act of 1934) during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 6. EXHIBITS

(a)

Exhibits:
See Exhibit Index

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EXHIBIT INDEX

| Exhibit Number | Exhibit Title |
|---------------------------|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of Chief Accounting Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification of Chief Executive Officer of Hilltop Holdings Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Accounting Officer of Hilltop Holdings Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |