

Hilltop Holdings Inc.  
Form 10-Q  
August 06, 2012  
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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 June 30, 2012

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)

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**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

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

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 August 6, 2012 was 56,363,647.

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**HILLTOP HOLDINGS INC.**

**FORM 10-Q**

**FOR THE QUARTER ENDED JUNE 30, 2012**

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Table of Contents**HILLTOP HOLDINGS INC.****CONSOLIDATED BALANCE SHEETS****AS OF JUNE 30, 2012 AND DECEMBER 31, 2011****(in thousands, except share and per share data)****(unaudited)**

	<b>June 30, 2012</b>	<b>December 31, 2011</b>
<b>Assets</b>		
Investments		
Fixed maturities		
Available for sale securities, at fair value (amortized cost of \$132,049 and \$135,166, respectively)	\$ 141,687	\$ 144,801
Equity securities		
Available for sale securities, at fair value (cost of \$19,008 and \$16,813, respectively)	19,610	19,022
Other investments		
Note receivable, at fair value (amortized cost of \$39,540 and \$38,641, respectively)	40,672	38,588
Warrants, at fair value (cost of \$12,068 and \$12,068, respectively)	13,905	21,789
Total investments	215,874	224,200
Cash and cash equivalents	576,412	578,520
Accrued interest and dividends	1,494	1,576
Premiums receivable	26,792	24,390
Deferred acquisition costs	20,631	19,182
Reinsurance recoverable, net of uncollectible amounts	23,135	25,861
Prepaid reinsurance premiums	3,189	5,056
Income taxes receivable	77	77
Deferred income taxes	16,300	8,354
Goodwill	23,988	23,988
Intangible assets, definite life	5,490	6,074
Intangible assets, indefinite life	3,000	3,000
Property and equipment, net	2,115	2,128
Loan origination costs, net	2,380	2,471
Other assets	1,221	548
Total assets	\$ 922,098	\$ 925,425
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 52,087	\$ 44,835
Unearned premiums	86,634	80,661
Reinsurance payable	3,057	2,845
Accounts payable and accrued expenses	7,293	8,121
Notes payable	131,450	131,450
Other liabilities	2,851	2,130
Total liabilities	283,372	270,042
<b>Stockholders Equity</b>		
Common stock, \$.01 par value, 100,000,000 shares authorized, 56,362,273 and 56,500,828 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively	564	565

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Additional paid-in capital	917,299	918,192
Accumulated other comprehensive income	8,586	13,983
Accumulated deficit	(287,723)	(277,357)
Total stockholders' equity	638,726	655,383
Total liabilities and stockholders' equity	\$ 922,098	\$ 925,425

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

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**HILLTOP HOLDINGS INC.**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME**  
**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
<b>Revenue:</b>				
Net premiums earned	\$ 36,195	\$ 32,568	\$ 71,350	\$ 63,500
Net investment income	3,223	2,229	6,482	4,310
Other income	1,851	1,723	3,562	3,348
Net realized gains on investments				
Other realized investment gains, net	17	12	38	31
Total realized investment gains, net	17	12	38	31
Total revenue	41,286	36,532	81,432	71,189
<b>Expenses:</b>				
Loss and loss adjustment expenses	39,071	41,101	61,613	57,105
Policy acquisition and other underwriting expenses	12,793	11,597	25,708	23,582
General and administrative expenses	2,913	1,612	4,557	3,485
Depreciation and amortization	330	426	690	858
Interest expense	2,131	2,245	4,270	4,421
Total expenses	57,238	56,981	96,838	89,451
Loss before income tax benefit	(15,952)	(20,449)	(15,406)	(18,262)
Income tax benefit	5,243	7,216	5,040	6,439
Net loss attributable to common stockholders	\$ (10,709)	\$ (13,233)	\$ (10,366)	\$ (11,823)
<b>Loss per share attributable to common stockholders</b>				
Basic loss per share	\$ (0.19)	\$ (0.23)	\$ (0.18)	\$ (0.21)
Diluted loss per share	\$ (0.19)	\$ (0.23)	\$ (0.18)	\$ (0.21)
<b>Weighted average share information</b>				
Basic shares outstanding	56,362	56,498	56,431	56,497
Diluted shares outstanding	56,362	56,498	56,431	56,497
<b>Other comprehensive (loss) income, before tax</b>				
Unrealized (losses) gains on available-for-sale securities	(3,071)	918	(8,303)	288
Income tax benefit (expense)	1,075	(321)	2,906	(101)
Other comprehensive (loss) income, net of tax	(1,996)	597	(5,397)	187
Comprehensive loss attributable to common stockholders	\$ (12,705)	\$ (12,636)	\$ (15,763)	\$ (11,636)

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



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**HILLTOP HOLDINGS INC.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2012**

(in thousands)

(unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders Equity
Balance, December 31, 2011	56,501	\$ 565	\$ 918,192	\$ 13,983	\$ (277,357)	\$ 655,383
Net loss					(10,366)	(10,366)
Other comprehensive loss, net of tax benefit of \$2,906				(5,397)		(5,397)
Total comprehensive loss						(15,763)
Common stock issued to board members	2		24			24
Repurchase of common stock	(141)	(1)	(1,161)			(1,162)
Stock compensation expense			244			244
Balance, June 30, 2012	56,362	\$ 564	\$ 917,299	\$ 8,586	\$ (287,723)	\$ 638,726

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



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**HILLTOP HOLDINGS INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

(in thousands)

(unaudited)

	<b>For the Six Months Ended June 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash flow from operating activities:</b>		
Net loss	\$ (10,366)	\$ (11,823)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	690	858
Increase in deferred income taxes	(5,040)	(6,320)
Increase in unearned premiums	5,973	9,304
Increase in deferred acquisition costs	(1,449)	(2,380)
Realized gains on investments	(38)	(31)
Amortization of loan origination costs	91	98
Stock grant compensation expense	268	34
Decrease in payable to related party		(263)
Increase in income taxes payable		21
Increase in premiums receivable	(2,402)	(3,103)
Decrease in reinsurance recoverables	2,726	3,734
Increase in loss and loss adjustment expense reserves	7,252	9,734
Changes in other operating assets and liabilities	723	226
Net cash (used in) provided by operating activities	\$ (1,572)	\$ 89
<b>Cash flow from investing activities:</b>		
Purchases of available-for-sale securities	\$ (2,717)	\$ (16,321)
Proceeds from sales of available-for-sale securities	2,075	2,392
Proceeds from maturities of available-for-sale securities	1,361	3,803
Purchases of fixed assets	(93)	(242)
Net cash provided by (used in) investing activities	\$ 626	\$ (10,368)
<b>Cash flow from financing activities:</b>		
Repurchase of common stock	\$ (1,162)	\$
Net cash used in financing activities	\$ (1,162)	\$
Net decrease in cash and cash equivalents	(2,108)	(10,279)
Cash and cash equivalents, beginning of period	578,520	649,439
Cash and cash equivalents, end of period	\$ 576,412	\$ 639,160
<b>Supplemental cash flow information:</b>		
Cash paid for interest	\$ 4,180	\$ 4,386

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



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**HILLTOP HOLDINGS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

**(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 or effect a business combination. In connection with this strategy, on May 8, 2012, we entered into a definitive agreement and plan of merger with PlainsCapital Corporation. In accordance with the merger agreement, PlainsCapital Corporation will become a wholly owned subsidiary of us. The purchase consideration to PlainsCapital Corporation shareholders includes approximately 27.5 million shares of our common stock and approximately \$318 million of cash. Consummation of the merger is subject to certain closing conditions, including approval of PlainsCapital Corporation's and our respective shareholders and regulatory approvals. No assurance can be given at this time as to when or if this transaction will be consummated.

We also conduct operations in the property and casualty insurance industry through our insurance subsidiaries, National Lloyds Insurance Company, or NLIC, and American Summit Insurance Company, or ASIC. National Lloyds Insurance Company commenced business in 1949 and currently operates in 14 states, with its largest market being the State of Texas. American Summit Insurance Company was formed in 1955 and currently operates in 12 states, its largest market being the State of Arizona. Both of these insurance companies carry a financial strength rating of A (Excellent) by A.M. Best, which was confirmed on March 30, 2012, and are regulated by the Texas Department of Insurance. Our products include fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States.

Our common stock is listed on the New York Stock Exchange under the symbol HTH. 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.

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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 statement 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 periods ended June 30, 2012 may not be indicative of the results that may be expected for the year ended December 31, 2012. These financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011.

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 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**

**JUNE 30, 2012**

**(unaudited)**

**Summary of Significant Accounting Policies**

*Recently Adopted Accounting Pronouncements*

In October 2010, the FASB issued ASU-2010-26 to address the diversity in practice for the accounting for costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost must be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. If application of this guidance would result in the capitalization of acquisition costs that had not previously been capitalized by a reporting entity, the entity may elect not to capitalize those costs. The updated guidance is effective for periods beginning after December 15, 2011. The Company adopted this guidance prospectively on January 1, 2012, and it had no material impact on the Company's financial statements.

In May 2011, the FASB issued ASU-2011-04 to clarify ASC 820 and in some instances changed particular principles or requirements for measuring fair value or disclosing information about fair value measurements. The amendments in this update result in common fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). This updated guidance is effective for periods beginning after December 15, 2011. The adoption of this guidance on January 1, 2012 did not have a material impact on the Company's financial statements.

In June 2011, the FASB issued ASU-2011-05, which eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. The new standard allows companies to report net income and other comprehensive income in a single, continuous statement, or in two separate, but consecutive statements. The statement(s) would need to be presented with equal prominence as the other primary financial statements. This updated guidance is effective for periods beginning after December 15, 2011. The adoption of this guidance on January 1, 2012 changed our current presentation of other comprehensive income; however, it did not have a material impact on the Company's financial statements.

In December 2011, the FASB issued ASU-2011-12, which amended ASU-2011-05 and defers guidance related to the presentation of reclassification adjustments out of accumulated other comprehensive income. All other requirements presented in ASU-2011-05 are not affected by this Update. This updated guidance is effective for periods beginning after December 15, 2011. The adoption of this guidance on January 1, 2012 changed our current presentation of other comprehensive income; however, it did not have a material impact on the Company's financial statements.



Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****JUNE 30, 2012****(unaudited)****2. Investments**

The amortized cost (original cost for equity securities), gross unrealized holding gains and losses, and fair value of available-for-sale securities by major security type and class of security at June 30, 2012 and December 31, 2011 were as follows (in thousands).

	<b>June 30, 2012</b>			
	<b>Cost/Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>Available-for-sale securities:</b>				
<b>Fixed maturities:</b>				
Government securities	\$ 27,756	\$ 1,270	\$ (1)	\$ 29,025
Residential mortgage-backed securities	10,373	797		11,170
Commercial mortgage-backed securities	1,969	64		2,033
Corporate debt securities	91,951	7,574	(66)	99,459
	132,049	9,705	(67)	141,687
Equity securities	19,008	608	(6)	19,610
	151,057	10,313	(73)	161,297
<b>Other investments:</b>				
Note receivable	39,540	1,132		40,672
Warrants	12,068	1,837		13,905
	\$ 202,665	\$ 13,282	\$ (73)	\$ 215,874

	<b>December 31, 2011</b>			
	<b>Cost/Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>Available-for-sale securities:</b>				
<b>Fixed maturities:</b>				
Government securities	\$ 27,729	\$ 1,439	\$ (3)	\$ 29,165
Residential mortgage-backed securities	11,708	944		12,652
Commercial mortgage-backed securities	2,277	36	(10)	2,303

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Corporate debt securities	93,452	7,406	(177)	100,681
	135,166	9,825	(190)	144,801
Equity securities	16,813	2,462	(253)	19,022
	151,979	12,287	(443)	163,823
Other investments:				
Note receivable	38,641		(53)	38,588
Warrants	12,068	9,721		21,789
	\$ 202,688	\$ 22,008	\$ (496)	\$ 224,200



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**HILLTOP HOLDINGS INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

(unaudited)

The following tables summarize the length of time securities with unrealized losses at June 30, 2012 and December 31, 2011 have been in an unrealized loss position (in thousands).

	Less than 12 Months		June 30, 2012 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	\$ 398	\$ (1)	\$	\$	\$ 398	\$ (1)
Corporate debt securities	720	(37)	1,723	(29)	2,443	(66)
	1,118	(38)	1,723	(29)	2,841	(67)
Equity securities						
			93	(6)	93	(6)
	\$ 1,118	\$ (38)	\$ 1,816	\$ (35)	\$ 2,934	\$ (73)

	Less than 12 Months		December 31, 2011 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	\$ 1,695	\$ (3)	\$	\$	\$ 1,695	\$ (3)
Commercial mortgage-backed securities	487	(10)			487	(10)
Corporate debt securities	5,254	(177)			5,254	(177)
	7,436	(190)			7,436	(190)
Equity securities						
	8,476	(253)			8,476	(253)
	15,912	(443)			15,912	(443)
Other investments						
Note receivable	38,588	(53)			38,588	(53)
	\$ 54,500	\$ (496)	\$	\$	\$ 54,500	\$ (496)

For the three and six months ended June 30, 2012, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, our analysis and experience indicate that these investments generally do not present a greater risk of other-than-temporary impairment, as fair value should recover over time. Factors considered in our analysis include the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted

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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 believed to be significant enough to warrant other-than-temporary impairment of the securities. The Company does not intend, nor is it likely that the Company will be required to sell these securities before the recovery of the cost basis; and, therefore, we do not believe any other-than-temporary impairments exist as of June 30, 2012.

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Gross realized investment gains and losses for the three and six months ended June 30, 2012 and 2011 are summarized as follows (in thousands).

	Gross Gains	2012 Gross Losses	Three Months Ended June 30,			
			Total	Gross Gains	2011 Gross Losses	Total
Fixed maturities	\$ 19	\$ (2)	\$ 17	\$ 13	\$ (1)	\$ 12
	\$ 19	\$ (2)	\$ 17	\$ 13	\$ (1)	\$ 12

	Gross Gains	2012 Gross Losses	Six Months Ended June 30,			
			Total	Gross Gains	2011 Gross Losses	Total
Fixed maturities	\$ 40	\$ (2)	\$ 38	\$ 33	\$ (2)	\$ 31
	\$ 40	\$ (2)	\$ 38	\$ 33	\$ (2)	\$ 31

Sale of available-for-sale investment securities resulted in the following during the three and six months ended June 30, 2012 and 2011 (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Proceeds	\$ 1,080	\$ 877	\$ 2,075	\$ 2,392
Gross gains	\$ 19	\$ 13	\$ 40	\$ 33
Gross losses	\$ (2)	\$ (1)	\$ (2)	\$ (2)

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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 securities at June 30, 2012 and December 31, 2011, by contractual maturity are as follows (in thousands).

	<b>June 30, 2012</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Available-for-sale fixed maturities:</b>		
Due within one year	\$ 28,682	\$ 29,156
Due after one year through five years	53,382	56,644
Due six years through ten years	36,728	41,729
Due after ten years	915	955
Mortgage-backed securities	12,342	13,203
	<b>\$ 132,049</b>	<b>\$ 141,687</b>
<b>Other investments:</b>		
Due after one year through five years	\$ 51,608	\$ 54,577
	<b>\$ 51,608</b>	<b>\$ 54,577</b>

	<b>December 31, 2011</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Available-for-sale fixed maturities:</b>		
Due within one year	\$ 12,608	\$ 12,942
Due after one year through five years	69,594	73,300
Due six years through ten years	38,065	42,766
Due after ten years	914	838
Mortgage-backed securities	13,985	14,955
	<b>\$ 135,166</b>	<b>\$ 144,801</b>
<b>Other investments:</b>		
Due after one year through five years	\$ 50,709	\$ 60,377
	<b>\$ 50,709</b>	<b>\$ 60,377</b>

Net investment income for the three and six months ended June 30, 2012 and 2011 is as follows (in thousands).

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	Three Months Ended June 30,			Six Months Ended June 30,		
	2012	2011	Change	2012	2011	Change
Cash equivalents	\$ 206	\$ 602	\$ (396)	\$ 389	\$ 1,219	\$ (830)
Fixed maturities	1,977	1,587	390	3,958	3,023	935
Equity securities	166	168	(2)	357	331	26
Other Investments	1,000		1,000	2,000		2,000
	3,349	2,357	992	6,704	4,573	2,131
Investment expense	(126)	(128)	2	(222)	(263)	41
Net investment income	\$ 3,223	\$ 2,229	\$ 994	\$ 6,482	\$ 4,310	\$ 2,172

At June 30, 2012, the Company had investments with carrying values totaling \$9.4 million on deposit with various state insurance departments.

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**HILLTOP HOLDINGS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

**(unaudited)**

**3. Fair Value Measurements**

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in ASC 820, *Fair Value Measurements and Disclosures*. The framework is based on the inputs used in valuation and gives the highest priority to quoted prices in active markets. It also requires that observable inputs be used in the valuations, when available. The 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. Based on management's understanding of the methodologies used by our pricing service, all applicable investments have been valued in accordance with GAAP valuation principles.
  
- 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.

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****JUNE 30, 2012****(unaudited)**

The following tables present the hierarchy of inputs used by the Company by financial asset type to determine their fair values at June 30, 2012 and December 31, 2011 (in thousands).

	Total	As of June 30, 2012		Level 3
		Level 1	Level 2	
Financial assets:				
<b>Cash and cash equivalents</b>	\$ 576,412	\$ 576,412	\$	\$
<b>Fixed maturities</b>				
Government securities	29,025		29,025	
Residential mortgage-backed securities	11,170		11,170	
Commercial mortgage-backed securities	2,033		2,033	
Corporate debt securities	99,459		99,459	
<b>Equity securities</b>				
Common stock	17,202	17,202		
Non-redeemable preferred stock	2,408	2,408		
<b>Other investments</b>				
Note receivable	40,672			40,672
Warrants	13,905			13,905
<b>Total</b>	<b>\$ 792,286</b>	<b>\$ 596,022</b>	<b>\$ 141,687</b>	<b>\$ 54,577</b>

	Total	As of December 31, 2011		Level 3
		Level 1	Level 2	
Financial assets:				
<b>Cash and cash equivalents</b>	\$ 578,520	\$ 578,520	\$	\$
<b>Fixed maturities</b>				
Government securities	29,165		29,165	
Residential mortgage-backed securities	12,652		12,652	
Commercial mortgage-backed securities	2,303		2,303	
Corporate debt securities	100,681		100,681	
<b>Equity securities</b>				
Common stock	18,774	18,774		
Non-redeemable preferred stock	248	248		
<b>Other investments</b>				
Note receivable	38,588			38,588
Warrants	21,789			21,789
<b>Total</b>	<b>\$ 802,720</b>	<b>\$ 597,542</b>	<b>\$ 144,801</b>	<b>\$ 60,377</b>

**Level 1 financial assets**

The Company's Level 1 investments include cash and cash equivalent balances and actively-traded 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. The Company receives the quoted market prices from a third party, nationally recognized, pricing service.

**Level 2 financial assets**

When quoted market prices are unavailable, the Company utilizes a third party pricing service to determine an estimate of fair value, which is mainly used for its fixed maturity investments, such as private and corporate debt securities, federal agency and municipal bonds, and non-government mortgage and asset-backed securities. The observable inputs utilized by the pricing service include interest rates, using either a market or income valuation approach to determine fair value. The extent of the use of each market input depends on the asset class and the market conditions; and, for some securities, additional inputs may be necessary. Based on management's understanding of the methodologies used by this pricing service, all applicable investments have been valued in accordance with GAAP valuation principles.



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**HILLTOP HOLDINGS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

**(unaudited)**

As the Company is responsible for the determination of fair value, we have control processes designed to ensure that the fair values received from third-party pricing sources are reasonable and the valuation techniques and assumptions used appear reasonable and consistent with prevailing market conditions. As part of these controls, we perform monthly quantitative and qualitative analysis on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. The Company's analysis includes: (i) a review of the methodology used by third party pricing services; (ii) where available, a comparison of multiple pricing services' valuations for the same security; (iii) a review of month to month price fluctuations; (iv) a review to ensure valuations are not unreasonably stale; and (v) back testing to compare actual purchase and sale transactions with valuations received from third parties. As a result of such procedures, the Company may conclude the prices received from third parties are not reflective of current market conditions. In those instances, we may request additional pricing quotes or apply internally developed valuations. However, the number of instances is insignificant and the aggregate change in value of such investments is not materially different from the original prices received.

**Level 3 financial assets**

The Company's Level 3 investments include the term loan issued to SWS Group, Inc., or SWS, and the warrants issued to us by SWS. 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. The extent of the use of each market input depends on the asset class and the market conditions; and, for some securities, additional inputs may be necessary.

The SWS term loan cash flow model utilizes yield estimates based on comparable securities in the market. Interest rate is the most significant unobservable input. An increase or decrease in the discount rate would result in an increase or decrease in the fair value measurement of the term loan.

The warrants are valued utilizing a binomial model. SWS common stock price and its related volatility, an unobservable input, are the most significant inputs into the model and, therefore, increases or decreases to the stock price would result in a significant change in the fair value measurement of the warrants.

The following table is a roll-forward of the amounts at June 30, 2012 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. The Company held no financial instruments classified within Level 3 during the six months ended June 30, 2011.

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Six Months Ended

Balance at December 31, 2011	\$	60,377
Net transfers in		
Purchases		
Sales		
Realized losses		
Net unrealized losses		(5,800)
Balance at June 30, 2012	\$	54,577

All net unrealized losses in the table above are reflected in the accompanying financial statements. The Company had no transfers between Levels 1 and 2 for the six months ended June 30, 2012.

The following tables present the carrying value and fair value of liabilities where they differ in value at June 30, 2012 and December 31, 2011 (in thousands).

	Carrying Value	Fair Value	June 30, 2012			December 31, 2011	
			Level 1	Level 2	Level 3	Carrying Value	Fair Value
<b>Financial liabilities</b>							
Notes payable	\$ 131,450	\$ 133,293		\$ 133,293		\$ 131,450	\$ 129,989

Table of Contents**HILLTOP HOLDINGS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****JUNE 30, 2012****(unaudited)****4. Reserve for Unpaid Losses and Loss Adjustment Expenses**

A roll forward of the reserve for unpaid losses and loss adjustment expenses for the six months ended June 30, 2012 and 2011 is as follows (in thousands).

	<b>Six Months Ended June 30,</b>	
	<b>2012</b>	<b>2011</b>
Balance at January 1	\$ 44,835	\$ 58,882
Less reinsurance recoverables	(25,083)	(43,773)
Net balance at January 1	19,752	15,109
Incurred related to:		
Current Year	59,340	56,775
Prior Year	2,273	330
Total incurred	61,613	57,105
Payments related to:		
Current Year	(38,845)	(37,059)
Prior Year	(11,798)	(6,700)
Total payments	(50,643)	(43,759)
Net balance at June 30	30,722	28,455
Plus reinsurance recoverables	21,365	40,161