

Hilltop Holdings Inc.  
Form 10-Q  
November 06, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2014

- o **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)

**200 Crescent Court, Suite 1330**  
**Dallas, TX**  
(Address of principal executive offices)

**84-1477939**  
(I.R.S. Employer Identification No.)

**75201**  
(Zip Code)

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(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   
(Do not check if a smaller reporting company)

Smaller reporting company

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

The number of shares of the registrant's common stock outstanding at November 5, 2014 was 90,181,888.

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**HILLTOP HOLDINGS INC.**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2014**

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(in thousands, except share and per share data)

	September 30, 2014 (Unaudited)	December 31, 2013
<b>Assets</b>		
Cash and due from banks	\$ 635,933	\$ 713,099
Federal funds sold and securities purchased under agreements to resell Securities:	11,655	32,924
Trading, at fair value	66,102	58,846
Available for sale, at fair value (amortized cost of \$1,152,117 and \$1,256,862, respectively)	1,146,101	1,203,143
Held to maturity, at amortized cost (fair value of \$119,901)	120,139	
	1,332,342	1,261,989
Loans held for sale	1,272,813	1,089,039
Non-covered loans, net of unearned income	3,768,843	3,514,646
Allowance for non-covered loan losses	(39,027)	(33,241)
Non-covered loans, net	3,729,816	3,481,405
Covered loans, net of allowance of \$3,761 and \$1,061, respectively	747,514	1,005,308
Broker-dealer and clearing organization receivables	223,679	119,317
Insurance premiums receivable	27,155	25,597
Deferred policy acquisition costs	21,754	20,991
Premises and equipment, net	205,734	200,706
FDIC indemnification asset	149,788	188,291
Covered other real estate owned	126,798	142,833
Mortgage servicing rights	41,907	20,149
Other assets	339,197	279,745
Goodwill	251,808	251,808
Other intangible assets, net	62,509	70,921
Total assets	\$ 9,180,402	\$ 8,904,122
<b>Liabilities and Stockholders Equity</b>		
Deposits:		
Noninterest-bearing	\$ 1,988,066	\$ 1,773,749
Interest-bearing	4,248,216	4,949,169
Total deposits	6,236,282	6,722,918
Broker-dealer and clearing organization payables	243,835	129,678
Reserve for losses and loss adjustment expenses	32,460	27,468
Unearned insurance premiums	93,500	88,422
Short-term borrowings	845,984	342,087
Notes payable	55,684	56,327
Junior subordinated debentures	67,012	67,012
Other liabilities	181,901	158,288
Total liabilities	7,756,658	7,592,200
Commitments and contingencies (see Notes 11 and 12)		
Stockholders equity:		
Hilltop stockholders equity:		
Preferred stock, \$0.01 par value, 10,000,000 shares authorized;		
Series B, liquidation value per share of \$1,000; 114,068 shares issued and outstanding	114,068	114,068

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Common stock, \$0.01 par value, 125,000,000 and 100,000,000 shares authorized; 90,179,596 and 90,175,688 shares issued and outstanding, respectively	902	902
Additional paid-in capital	1,390,830	1,388,641
Accumulated other comprehensive loss	(3,727)	(34,863)
Accumulated deficit	(79,098)	(157,607)
Total Hilltop stockholders' equity	1,422,975	1,311,141
Noncontrolling interest	769	781
Total stockholders' equity	1,423,744	1,311,922
Total liabilities and stockholders' equity	\$ 9,180,402	\$ 8,904,122

*See accompanying notes.*

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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Interest income:</b>				
Loans, including fees	\$ 80,719	\$ 68,585	\$ 252,667	\$ 198,684
<b>Securities:</b>				
Taxable	7,688	7,202	22,894	19,594
Tax-exempt	1,150	1,052	3,579	3,588
Federal funds sold and securities purchased under agreements to resell	10	35	43	91
Interest-bearing deposits with banks	303	282	1,215	857
Other	3,347	2,546	9,055	7,660
<b>Total interest income</b>	<b>93,217</b>	<b>79,702</b>	<b>289,453</b>	<b>230,474</b>
<b>Interest expense:</b>				
Deposits	4,117	3,685	10,972	10,541
Short-term borrowings	665	384	1,599	1,488
Notes payable	633	2,294	1,913	6,924
Junior subordinated debentures	594	591	1,765	1,811
Other	1,448	832	3,577	2,108
<b>Total interest expense</b>	<b>7,457</b>	<b>7,786</b>	<b>19,826</b>	<b>22,872</b>
<b>Net interest income</b>	<b>85,760</b>	<b>71,916</b>	<b>269,627</b>	<b>207,602</b>
Provision for loan losses	4,033	10,658	12,808	34,952
<b>Net interest income after provision for loan losses</b>	<b>81,727</b>	<b>61,258</b>	<b>256,819</b>	<b>172,650</b>
<b>Noninterest income:</b>				
Net realized gains on securities		1,142		1,142
Net gains from sale of loans and other mortgage production income	108,621	105,337	293,786	375,464
Mortgage loan origination fees	17,593	22,091	46,920	63,679
Net insurance premiums earned	41,821	39,982	122,917	116,045
Investment and securities advisory fees and commissions	24,055	22,310	67,654	70,283
Bargain purchase gain		12,585		12,585
Other	20,045	11,648	54,239	28,408
<b>Total noninterest income</b>	<b>212,135</b>	<b>215,095</b>	<b>585,516</b>	<b>667,606</b>
<b>Noninterest expense:</b>				
Employees compensation and benefits	126,406	119,176	357,280	368,081
Loss and loss adjustment expenses	22,629	24,631	76,241	93,976
Policy acquisition and other underwriting expenses	11,571	11,739	34,910	34,169
Occupancy and equipment, net	25,345	20,974	77,445	60,540
Other	68,793	40,072	172,709	135,217

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Total noninterest expense	254,744	216,592	718,585	691,983
Income before income taxes	39,118	59,761	123,750	148,273
Income tax expense	14,010	20,115	44,658	52,594
Net income	25,108	39,646	79,092	95,679
Less: Net income attributable to noncontrolling interest	296	339	583	1,207
Income attributable to Hilltop	24,812	39,307	78,509	94,472
Dividends on preferred stock	1,426	1,133	4,278	2,985
Income applicable to Hilltop common stockholders	\$ 23,386	\$ 38,174	\$ 74,231	\$ 91,487
Earnings per common share:				
Basic	\$ 0.26	\$ 0.45	\$ 0.82	\$ 1.09
Diluted	\$ 0.26	\$ 0.43	\$ 0.82	\$ 1.05
Weighted average share information:				
Basic	89,711	83,493	89,709	83,490
Diluted	90,558	90,460	90,570	90,251

*See accompanying notes.*

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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$ 25,108	\$ 39,646	\$ 79,092	\$ 95,679
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale, net of tax of \$(656), \$1,135, \$16,565 and \$(13,641), respectively	(1,226)	2,109	31,136	(25,332)
Comprehensive income	23,882	41,755	110,228	70,347
Less: comprehensive income attributable to noncontrolling interest	296	339	583	1,207
Comprehensive income applicable to Hilltop	\$ 23,586	\$ 41,416	\$ 109,645	\$ 69,140

*See accompanying notes.*

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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(in thousands)

(Unaudited)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Hilltop Stockholders Equity	Noncontrolling Interest	Total Stockholders Equity
	Shares	Amount	Shares	Amount						
Balance, December 31, 2012	114	\$ 114,068	83,487	\$ 835	\$ 1,304,448	\$ 8,094	\$ (282,949)	\$ 1,144,496	\$ 2,054	\$ 1,146,550
Net income							94,472	94,472	1,207	95,679
Other comprehensive loss						(25,332)		(25,332)		(25,332)
Stock-based compensation expense					1,071			1,071		1,071
Common stock issued to board members			7		96			96		96
Issuance of restricted common stock			465	5	(5)					
Dividends on preferred stock					(2,985)			(2,985)		(2,985)
Cash distributions to noncontrolling interest									(2,383)	(2,383)
Balance, September 30, 2013	114	\$ 114,068	83,959	\$ 840	\$ 1,302,625	\$ (17,238)	\$ (188,477)	\$ 1,211,818	\$ 878	\$ 1,212,696
Balance, December 31, 2013	114	\$ 114,068	90,176	\$ 902	\$ 1,388,641	\$ (34,863)	\$ (157,607)	\$ 1,311,141	\$ 781	\$ 1,311,922
Net income							78,509	78,509	583	79,092
Other comprehensive income						31,136		31,136		31,136
Stock-based compensation expense					3,316			3,316		3,316
Common stock issued to board members			7		162			162		162
Forfeiture of restricted common stock awards			(3)		(12)			(12)		(12)
Dividends on preferred stock					(4,278)			(4,278)		(4,278)
Issuance of common stock					3,001			3,001		3,001
Cash distributions to noncontrolling interest									(595)	(595)
Balance, September 30, 2014	114	\$ 114,068	90,180	\$ 902	\$ 1,390,830	\$ (3,727)	\$ (79,098)	\$ 1,422,975	\$ 769	\$ 1,423,744

See accompanying notes.



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**HILLTOP HOLDINGS INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Operating Activities</b>		
Net income	\$ 79,092	\$ 95,679
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	12,808	34,952
Depreciation, amortization and accretion, net	(63,367)	(24,788)
Net realized gains on securities		(1,142)
Bargain purchase gain		(12,585)
Deferred income taxes	6,418	(11,423)
Other, net	16,669	3,914
Net change in trading securities	(7,256)	46,859
Net change in broker-dealer and clearing organization receivables	(164,497)	2,796
Net change in other assets	(40,193)	22,851
Net change in broker-dealer and clearing organization payables	261,206	(37,386)
Net change in loss and loss adjustment expense reserve	4,992	(2,745)
Net change in unearned insurance premiums	5,078	9,466
Net change in other liabilities	20,233	(18,510)
Net gains from sale of loans	(293,786)	(375,464)
Loans originated for sale	(7,954,706)	(9,427,627)
Proceeds from loans sold	8,067,301	10,157,410
Net cash provided by (used in) operating activities	(50,008)	462,257
<b>Investing Activities</b>		
Proceeds from maturities and principal reductions of securities held to maturity	2,821	
Proceeds from sales, maturities and principal reductions of securities available for sale	152,537	211,732
Purchases of securities held to maturity	(123,021)	
Purchases of securities available for sale	(48,730)	(255,142)
Net change in loans	106,335	(48,859)
Purchases of premises and equipment and other assets	(32,581)	(20,264)
Proceeds from sales of premises and equipment and other real estate owned	55,097	7,641
Net cash paid (received) for Federal Home Loan Bank and Federal Reserve Bank stock	(28,383)	89
Net cash from FNB Transaction		362,695
Net cash provided by investing activities	84,075	257,892
<b>Financing Activities</b>		
Net change in deposits	(633,685)	(1,476)
Net change in short-term borrowings	503,897	(422,953)
Proceeds from notes payable	2,000	1,000
Payments on notes payable	(2,643)	(2,428)
Dividends paid on preferred stock	(4,194)	(1,852)
Net cash distributed to noncontrolling interest	(595)	(2,383)
Other, net	2,718	(243)
Net cash used in financing activities	(132,502)	(430,335)

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Net change in cash and cash equivalents		(98,435)		289,814
Cash and cash equivalents, beginning of period		746,023		726,460
Cash and cash equivalents, end of period	\$	647,588	\$	1,016,274

**Supplemental Disclosures of Cash Flow Information**

Cash paid for interest	\$	20,935	\$	22,513
Cash paid for income taxes, net of refunds	\$	19,893	\$	52,752

**Supplemental Schedule of Non-Cash Activities**

Conversion of loans to other real estate owned	\$	44,815	\$	6,019
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*See accompanying notes.*

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

**1. Summary of Significant Accounting and Reporting Policies**

**Nature of Operations**

Hilltop Holdings Inc. ( Hilltop and, collectively with its subsidiaries, the Company ) is a financial holding company registered under the Bank Holding Company Act of 1956, as amended by the Gramm-Leach-Bliley Act of 1999. On November 30, 2012, Hilltop acquired PlainsCapital Corporation pursuant to a plan of merger whereby PlainsCapital Corporation merged with and into a wholly owned subsidiary of Hilltop (the PlainsCapital Merger ), which continued as the surviving entity under the name PlainsCapital Corporation ( PlainsCapital ).

The Company has two primary operating business units, PlainsCapital and National Lloyds Corporation ( NLC ). PlainsCapital is a financial holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, an array of financial products and services. In addition to traditional banking services, PlainsCapital provides residential mortgage lending, investment banking, public finance advisory, wealth and investment management, treasury management, capital equipment leasing, fixed income sales, asset management, and correspondent clearing services. NLC is a property and casualty insurance holding company that provides, through its subsidiaries, fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States.

On September 13, 2013 (the Bank Closing Date ), PlainsCapital Bank (the Bank ) assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of Edinburg, Texas-based First National Bank ( FNB ) from the Federal Deposit Insurance Corporation (the FDIC ), as receiver, and reopened former FNB branches acquired from the FDIC under the PlainsCapital Bank name (the FNB Transaction ). Pursuant to the Purchase and Assumption Agreement (the P&A Agreement ), the Bank and the FDIC entered into loss-share agreements whereby the FDIC agreed to share in the losses of certain covered loans and covered other real estate owned ( OREO ) that the Bank acquired, as further described in Note 2 to the consolidated financial statements. The fair value of the assets acquired was \$2.2 billion, including \$1.1 billion in covered loans, \$286.2 million in securities, \$135.2 million in covered OREO and \$42.9 million in non-covered loans. The Bank also assumed \$2.2 billion in liabilities, consisting primarily of deposits. The acquisition of FNB 's expansive branch network allowed the Bank to increase its presence in Texas to include the Rio Grande Valley, Houston, Corpus Christi, Laredo and El Paso markets, among others.

On March 31, 2014, the Company entered into a definitive merger agreement with SWS Group, Inc. ( SWS ) providing for the merger of SWS with and into Peruna LLC, a wholly owned subsidiary of Hilltop formed for the purpose of facilitating this transaction. SWS stockholders will receive per share consideration of 0.2496 shares of Hilltop common stock and \$1.94 of cash, equating to \$6.94 per share based on Hilltop 's closing price on September 30, 2014. The value of the merger consideration will fluctuate with the market price of Hilltop common stock. The Company intends to fund the cash portion of the consideration through available cash. The merger is subject to customary closing conditions, including regulatory approvals and approval of the stockholders of SWS, and is expected to be completed prior to the end of 2014.

**Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States ( GAAP ), and in conformity with the rules and regulations of the Securities and Exchange Commission (the SEC ). In the opinion of management, these financial statements contain all adjustments necessary for a fair statement of the results of the interim periods presented. Accordingly, the financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2013. Results for interim periods are not necessarily indicative of results to be expected for a full year or any future period.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at

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### Hilltop Holdings Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements (continued)

(Unaudited)

the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates regarding the allowance for loan losses, the fair values of financial instruments, the amounts receivable under the loss-share agreements with the FDIC ( FDIC Indemnification Asset ), reserves for losses and loss adjustment expenses, the mortgage loan indemnification liability, and the potential impairment of assets are particularly subject to change. The Company has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements.

Certain reclassifications have been made to the prior period consolidated financial statements to conform with the current period presentation.

Management made significant estimates and exercised significant judgment in estimating fair values and accounting associated with the FNB Transaction during the third quarter of 2013 due to the short time period between the Bank Closing Date and September 30, 2013. The Bank Closing Date valuations related to loans, FDIC Indemnification Asset, covered OREO, other intangible assets, assumed liabilities and taxes were considered preliminary at September 30, 2013. The operations of FNB were included in the Company's operating results beginning September 14, 2013 and such operations included a preliminary bargain purchase gain of \$3.3 million, before income taxes of \$1.2 million, as disclosed in the Company's Quarterly Report on Form 10-Q filed with the SEC on November 12, 2013.

During the quarter ended December 31, 2013, the estimated fair values of certain identifiable assets acquired and liabilities assumed as of the Bank Closing Date were adjusted in accordance with the Business Combinations Topic of the Accounting Standards Codification ( ASC ) as a result of additional information obtained about the facts and circumstances that existed as of the Bank Closing Date primarily related to the fair values of loans, covered OREO, FDIC Indemnification Asset, premises and equipment and other intangible assets. These adjustments resulted in an increase in the preliminary bargain purchase gain associated with the FNB Transaction to \$12.6 million, before income taxes of \$4.5 million. This change is reflected in the revised consolidated statements of operations within noninterest income during the three and nine months ended September 30, 2013. In the aggregate, the adjustments to the preliminary bargain purchase gain and related revisions to the accretion of discount on loans and other items increased net income for the three and nine months ended September 30, 2013 by \$6.3 million as compared with amounts previously reported in the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013. Additionally, certain amounts previously reported in the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 within the consolidated balance sheet as of September 30, 2013, the related statements of comprehensive income (loss), stockholders' equity and cash flows for the three and nine months ended September 30, 2013, as well as the notes to the consolidated financial statements, have been revised accordingly.

Hilltop owns 100% of the outstanding stock of PlainsCapital. PlainsCapital owns 100% of the outstanding stock of the Bank and 100% of the membership interest in PlainsCapital Equity, LLC. The Bank owns 100% of the outstanding stock of PrimeLending, a PlainsCapital Company ( PrimeLending ), PCB-ARC, Inc. and RGV-ARC, Inc. The Bank has a 100% membership interest in First Southwest Holdings, LLC ( First Southwest ) and PlainsCapital Securities, LLC.

Hilltop also owns 100% of NLC, which operates through its wholly owned subsidiaries, National Lloyds Insurance Company ( NLIC ) and American Summit Insurance Company ( ASIC ).

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PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC, the controlling and sole managing member of PrimeLending Ventures, LLC ( Ventures ).

The principal subsidiaries of First Southwest are First Southwest Company ( FSC ), a broker-dealer registered with the SEC and the Financial Industry Regulatory Authority and a member of the New York Stock Exchange, and First Southwest Asset Management, Inc., a registered investment advisor under the Investment Advisors Act of 1940.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The consolidated financial statements include the accounts of the above-named entities. All significant intercompany transactions and balances have been eliminated. Noncontrolling interests have been recorded for minority ownership in entities that are not wholly owned and are presented in compliance with the provisions of Noncontrolling Interest in Subsidiary Subsections of the Financial Accounting Standards Board ( FASB ) ASC.

PlainsCapital also owns 100% of the outstanding common securities of PCC Statutory Trusts I, II, III and IV (the Trusts ), which are not included in the consolidated financial statements under the requirements of the Variable Interest Entities Subsections of the ASC, because the primary beneficiaries of the Trusts are not within the consolidated group.

## 2. Acquisitions

### *FNB Transaction*

On the Bank Closing Date, the Bank assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of FNB from the FDIC in an FDIC-assisted transaction. As part of the P&A Agreement, the Bank and the FDIC entered into loss-share agreements covering future losses incurred on certain acquired loans and OREO. The Company refers to acquired commercial and single family residential loan portfolios and OREO that are subject to the loss-share agreements as covered loans and covered OREO , respectively, and these assets are presented as separate line items in the Company s consolidated balance sheet. Collectively, covered loans and covered OREO are referred to as covered assets .

In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC s initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement.

The FNB Transaction was accounted for using the purchase method of accounting and, accordingly, purchased assets, including identifiable intangible assets and assumed liabilities, were recorded at their respective fair values as of the Bank Closing Date using significant estimates and assumptions to value certain identifiable assets acquired and liabilities assumed. The amounts are subject to adjustments based upon final settlement with the FDIC. The terms of the P&A Agreement provide for the FDIC to indemnify the Bank against claims with respect to liabilities and assets of FNB or any of its affiliates not assumed or otherwise purchased by the Bank and with respect to certain other claims by third parties.

*Pro Forma Results of Operations*

The operations acquired in the FNB Transaction are included in the Company's operating results beginning September 14, 2013. The purchase of assets and assumption of certain liabilities of FNB from the FDIC, as receiver, was sufficiently significant to require disclosure of historical financial statements and related pro forma financial disclosure. Due to the nature and magnitude of the FNB Transaction, coupled with the federal assistance and protection resulting from the FDIC loss-share agreements, historical financial information of FNB is not relevant to future operations. The Company has omitted certain historical financial information and the related pro forma financial information of FNB pursuant to the guidance provided in Staff Accounting Bulletin Topic 1.K, Financial Statements of Acquired Troubled Financial Institutions ( SAB 1:K ), and a request for relief granted by the SEC. SAB 1:K provides relief from the requirements of Rule 3-05 of Regulation S-X in certain instances, such as the FNB Transaction, where a registrant engages in an acquisition of a significant amount of assets of a troubled financial institution for which audited financial statements are not reasonably available and in which federal assistance is so persuasive as to substantially reduce the relevance of such information to an assessment of future operations.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**3. Fair Value Measurements**

*Fair Value Measurements and Disclosures*

The Company determines fair values in compliance with The Fair Value Measurements and Disclosures Topic of the ASC (the Fair Value Topic). The Fair Value Topic defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. The Fair Value Topic defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The Fair Value Topic assumes that transactions upon which fair value measurements are based occur in the principal market for the asset or liability being measured. Further, fair value measurements made under the Fair Value Topic exclude transaction costs and are not the result of forced transactions.

The Fair Value Topic creates a fair value hierarchy that classifies fair value measurements based upon the inputs used in valuing the assets or liabilities that are the subject of fair value measurements. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs, as indicated below.

- *Level 1 Inputs:* Unadjusted quoted prices in active markets for identical assets or liabilities that the Company can access at the measurement date.
- *Level 2 Inputs:* Observable inputs other than Level 1 prices. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates, yield curves, prepayment speeds, default rates, credit risks, loss severities, etc.), and inputs that are derived from or corroborated by market data, among others.
- *Level 3 Inputs:* Unobservable inputs that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. Level 3 inputs include pricing models and discounted cash flow techniques, among others.

*Fair Value Option*

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The Company has elected to measure substantially all of PrimeLending's mortgage loans held for sale and retained mortgage servicing rights (MSR) at fair value, under the provisions of the Fair Value Option. The Company elected to apply the provisions of the Fair Value Option to these items so that it would have the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The Company determines the fair value of the financial instruments accounted for under the provisions of the Fair Value Option in compliance with the provisions of the Fair Value Topic of the ASC discussed above.

At September 30, 2014, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.25 billion, and the unpaid principal balance of those loans was \$1.20 billion. At December 31, 2013, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.09 billion, and the unpaid principal balance of those loans was \$1.07 billion. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

The Company holds a number of financial instruments that are measured at fair value on a recurring basis, either by the application of the Fair Value Option or other authoritative pronouncements. The fair values of those instruments are determined primarily using Level 2 inputs. Those inputs include quotes from mortgage loan investors and derivatives dealers and data from independent pricing services.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables present information regarding financial assets and liabilities measured at fair value on a recurring basis (in thousands).

	Level 1 Inputs		Level 2 Inputs		Level 3 Inputs		Total Fair Value
<b>September 30, 2014</b>							
Trading securities	\$	36	\$	66,066	\$		\$ 66,102
Available for sale securities		23,983		1,060,835		61,283	1,146,101
Loans held for sale				1,235,870		13,763	1,249,633
Derivative assets				25,268			25,268
Mortgage servicing rights asset						41,907	41,907
Trading liabilities				47			47
Derivative liabilities				3,718		6,827	10,545

	Level 1 Inputs		Level 2 Inputs		Level 3 Inputs		Total Fair Value
<b>December 31, 2013</b>							
Trading securities	\$	33	\$	58,813	\$		\$ 58,846
Available for sale securities		22,079		1,121,011		60,053	1,203,143
Loans held for sale				1,061,310		27,729	1,089,039
Derivative assets				23,564			23,564
Mortgage servicing rights asset						20,149	20,149
Trading liabilities				46			46
Derivative liabilities				139		5,600	5,739

The following tables include a roll forward for those financial instruments measured at fair value using Level 3 inputs (in thousands).

	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Included in Net Income	Total Gains or Losses (Realized or Unrealized) Included in Other Comprehensive Income (Loss)	Balance at End of Period
<b>Three months ended</b>						
<b>September 30, 2014</b>						
Available for sale securities	\$ 63,819	\$	\$	\$ 639	\$ (3,175)	\$ 61,283
Loans held for sale	10,409	6,110	(1,600)	(1,156)		13,763
Mortgage servicing rights asset	35,877	18,982	(11,387)	(1,565)		41,907
Derivative liabilities	(6,300)	(177)		(350)		(6,827)
Total	\$ 103,805	\$ 24,915	\$ (12,987)	\$ (2,432)	\$ (3,175)	\$ 110,126

	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Included in Net Income	Total Gains or Losses (Realized or Unrealized) Included in Other Comprehensive Income (Loss)	Balance at End of Period
<b>Nine months ended</b>						
<b>September 30, 2014</b>						
Available for sale securities	\$ 60,053	\$	\$	\$ 1,848	\$ (618)	\$ 61,283
Loans held for sale	27,729	16,531	(31,203)	706		13,763

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Mortgage servicing rights asset	20,149	33,790	(11,387)	(645)	41,907
Derivative liabilities	(5,600)	(177)		(1,050)	(6,827)
Total	\$ 102,331	\$ 50,144	\$ (42,590)	\$ 859	\$ (618) \$ 110,126

**Three months ended**

**September 30, 2013**

Available for sale securities	\$ 55,510	\$	\$	\$ 551	\$ 3,541	\$ 59,602
Mortgage servicing rights asset	7,111	4,079		2,211		13,401
Derivative liabilities	(4,939)			(225)		(5,164)
Total	\$ 57,682	\$ 4,079	\$	\$ 2,537	\$ 3,541	\$ 67,839

**Nine months ended**

**September 30, 2013**

Available for sale securities	\$ 56,277	\$	\$	\$ 1,594	\$ 1,731	\$ 59,602
Mortgage servicing rights asset	2,080	8,384		2,937		13,401
Derivative liabilities	(4,490)			(674)		(5,164)
Total	\$ 53,867	\$ 8,384	\$	\$ 3,857	\$ 1,731	\$ 67,839

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

All net realized and unrealized gains (losses) in the tables above are reflected in the accompanying consolidated financial statements. The unrealized gains (losses) relate to financial instruments still held at September 30, 2014. The available for sale securities noted in the table above reflect Hilltop's note receivable and SWS Warrant (defined hereinafter) as discussed in Note 4 to the consolidated financial statements.

For Level 3 financial instruments measured at fair value on a recurring basis at September 30, 2014, the significant unobservable inputs used in the fair value measurements were as follows.

<b>Financial instrument</b>	<b>Valuation Technique</b>	<b>Unobservable Input</b>	<b>Weighted Average / Range</b>
Available for sale securities - note receivable	Discounted cash flow	Discount rate	8.45%
Available for sale securities - warrant	Binomial model	SWS common stock price volatility	29.0%
Loans held for sale	Discounted cash flow / Market comparable	Projected price	89 - 91%
Mortgage servicing rights asset	Discounted cash flow	Constant prepayment rate	9.51%
		Discount rate	11.03%
Derivative liabilities	Discounted cash flow	Discount rate	14 - 28%
		Time to receive full payment of cash flows	10.5 - 13.75 years

Hilltop's note receivable is valued using a cash flow model that estimates yield based on comparable securities in the market. The interest rate used to discount cash flows is the most significant unobservable input. An increase or decrease in the discount rate would result in a corresponding decrease or increase, respectively, in the fair value measurement of the note receivable.

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

The fair value of certain loans held for sale that are either non-standard (i.e. loans that cannot be sold through normal sale channels) or non-performing is measured using unobservable inputs. The fair value of such loans is generally based upon estimates of expected cash flows using unobservable inputs including listing prices of comparable assets, uncorroborated expert opinions, and/or management's knowledge of underlying collateral.

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The MSR asset is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the MSR asset is impacted by a variety of factors. Prepayment rates and discount rates, the most significant unobservable inputs, are discussed further in Note 7 to the consolidated financial statements.

Derivative liabilities in the tables above include a derivative option agreement ( Fee Award Option ) entered into by First Southwest and valued using discounted cash flows and probability of exercise.

The Company had no transfers between Levels 1 and 2 during the periods presented.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables present the changes in fair value for instruments that are reported at fair value under the Fair Value Option (in thousands).

	Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option Three Months Ended September 30, 2014			Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option Three Months Ended September 30, 2013		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	\$ (15,250)	\$	\$ (15,250)	\$ 44,395	\$	\$ 44,395
Mortgage servicing rights asset	(1,565)		(1,565)	2,211		2,211
Time deposits						

	Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option Nine Months Ended September 30, 2014			Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option Nine Months Ended September 30, 2013		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	\$ 24,918	\$	\$ 24,918	\$ 2,754	\$	\$ 2,754
Mortgage servicing asset	(645)		(645)	2,937		2,937
Time deposits					12	12

The Company also determines the fair value of certain assets and liabilities on a non-recurring basis. In addition, facts and circumstances may dictate a fair value measurement when there is evidence of impairment. Assets and liabilities measured on a non-recurring basis include the items discussed below.

**Impaired Loans** The Company reports impaired loans based on the underlying fair value of the collateral through specific allowances within the allowance for loan losses. Purchased credit impaired ( PCI ) loans with a fair value of \$172.9 million and \$822.8 million were acquired by the Company upon completion of the PlainsCapital Merger and the FNB Transaction, respectively. Substantially all PCI loans acquired in the FNB Transaction are covered by FDIC loss-share agreements. The fair value of PCI loans was determined using Level 3 inputs, including estimates of expected cash flows that incorporated significant unobservable inputs regarding default rates, loss severity rates assuming default, prepayment speeds and estimated collateral values. At September 30, 2014, these inputs included estimated weighted average default rates, loss severity rates and prepayment speed assumptions of 46%, 52% and 0%, respectively, for those PCI loans acquired in the PlainsCapital Merger and 63%, 38% and 4%, respectively, for those PCI loans acquired in the FNB Transaction. The resulting weighted average expected loss on PCI loans associated with each of the PlainsCapital Merger and the FNB Transaction was 24%.

The Company obtains updated appraisals of the fair value of collateral securing impaired collateral dependent loans at least annually, in accordance with regulatory guidelines. The Company also reviews the fair value of such collateral on a quarterly basis. If the quarterly review indicates that the fair value of the collateral may have deteriorated, the Company will order an updated appraisal of the fair value of the collateral. Since the Company obtains updated appraisals when evidence of a decline in the fair value of collateral exists, it typically does not

adjust appraised values.

**Other Real Estate Owned** The Company reports OREO at fair value less estimated cost to sell. Any excess of recorded investment over fair value, less cost to sell, is charged against either the allowance for loan losses or the related PCI pool discount when property is initially transferred to OREO. Subsequent to the initial transfer to OREO, downward valuation adjustments are charged against earnings. The Company determines fair value primarily using independent appraisals of OREO properties. The resulting fair value measurements are classified as Level 2 or Level 3 inputs, depending upon the extent to which unobservable inputs determine the fair value measurement. The Company considers a number of factors in determining the extent to which specific fair value measurements utilize unobservable inputs, including, but not limited to, the inherent subjectivity in appraisals, the length of time elapsed since the receipt of independent market price or appraised value, and current market conditions. At September 30, 2014, the most significant unobservable input used in the determination of fair value of OREO was a discount to independent appraisals for estimated holding periods of OREO properties. Such discount was 1% per month for estimated holding periods of 6 to 24 months. Level 3 inputs were used to determine the fair value of a large group of smaller balance properties that were acquired in the FNB Transaction. In the FNB Transaction, the Bank acquired OREO of \$135.2 million, all of which is covered by FDIC loss-share agreements. At

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

September 30, 2014 and December 31, 2013, the estimated fair value of covered OREO was \$126.8 million and \$142.8 million, respectively, and the underlying fair value measurements utilize Level 2 and Level 3 inputs. The fair value of non-covered OREO at September 30, 2014 and December 31, 2013 was \$2.3 million and \$4.8 million, respectively, and is included in other assets within the consolidated balance sheets. During the reported periods, all fair value measurements for non-covered OREO utilized Level 2 inputs.

The following table presents information regarding certain assets and liabilities measured at fair value on a non-recurring basis for which a change in fair value has been recorded during reporting periods subsequent to initial recognition (in thousands).

September 30, 2014	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value	Total Gains (Losses) for the		Total Gains (Losses) for the	
					Three Months Ended September 30, 2014	2013	Nine Months Ended September 30, 2014	2013
Non-covered impaired loans	\$	\$	\$ 30,061	\$ 30,061	\$ (1,714)	\$ (2,352)	\$ (2,151)	\$ (3,011)
Covered impaired loans			74,015	74,015	242		(2,790)	
Non-covered other real estate owned					(210)	(1,381)	(321)	(1,571)
Covered other real estate owned		45,050	20,803	65,853	(14,440)		(17,399)	

The Fair Value of Financial Instruments Subsection of the ASC requires disclosure of the fair value of financial assets and liabilities, including the financial assets and liabilities previously discussed. The methods for determining estimated fair value for financial assets and liabilities is described in detail in Note 3 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

The following tables present the carrying values and estimated fair values of financial instruments not measured at fair value on either a recurring or non-recurring basis (in thousands).

September 30, 2014	Carrying Amount	Level 1 Inputs	Estimated Fair Value		Total
			Level 2 Inputs	Level 3 Inputs	
Financial assets:					
Cash and cash equivalents	\$ 647,588	\$ 647,588	\$	\$	\$ 647,588
Held to maturity securities	120,139		119,901		119,901
Loans held for sale	23,180		23,180		23,180
Non-covered loans, net	3,729,816		341,846	3,406,917	3,748,763
Covered loans, net	747,514			823,111	823,111
Broker-dealer and clearing organization receivables	223,679		223,679		223,679

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FDIC indemnification asset	149,788		149,788	149,788
Other assets	63,925	42,301	21,624	63,925
<b>Financial liabilities:</b>				
Deposits	6,236,282	6,238,982		6,238,982
Broker-dealer and clearing organization payables	243,835	243,835		243,835
Short-term borrowings	845,984	845,984		845,984
Debt	122,696	116,007		116,007
Other liabilities	2,251	2,251		2,251

December 31, 2013	Carrying Amount	Level 1 Inputs	Estimated Fair Value		Total
			Level 2 Inputs	Level 3 Inputs	
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 746,023	\$ 746,023	\$	\$	\$ 746,023
Non-covered loans, net	3,481,405		281,712	3,119,319	3,401,031
Covered loans, net	1,005,308			997,371	997,371
Broker-dealer and clearing organization receivables	119,317		119,317		119,317
FDIC indemnification asset	188,291			188,291	188,291
Other assets	66,055		43,946	22,109	66,055
<b>Financial liabilities:</b>					
Deposits	6,722,019		6,722,909		6,722,909
Broker-dealer and clearing organization payables	129,678		129,678		129,678
Short-term borrowings	342,087		342,087		342,087
Debt	123,339		114,671		114,671
Other liabilities	3,362		3,362		3,362

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**4. Securities**

The amortized cost and fair value of securities, excluding trading securities, are summarized as follows (in thousands). No securities were classified as held to maturity at December 31, 2013.

September 30, 2014	Amortized Cost	Available for Sale		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
U.S. Treasury securities	\$ 44,709	\$ 149	\$ (64)	\$ 44,794
U.S. government agencies:				
Bonds	637,882	1,397	(18,522)	620,757
Residential mortgage-backed securities	53,780	1,626	(401)	55,005
Collateralized mortgage obligations	100,938	137	(4,093)	96,982
Corporate debt securities	95,251	4,795	(128)	99,918
States and political subdivisions	141,813	1,917	(1,007)	142,723
Commercial mortgage-backed securities	596	60		656
Equity securities	20,558	3,425		23,983
Note receivable	44,522	5,327		49,849
Warrant	12,068		(634)	11,434
Totals	\$ 1,152,117	\$ 18,833	\$ (24,849)	\$ 1,146,101

December 31, 2013	Amortized Cost	Available for Sale		Fair Value
		Unrealized Gains	Unrealized Losses	
U.S. Treasury securities	\$ 43,684	\$ 82	\$ (238)	\$ 43,528
U.S. government agencies:				
Bonds	717,909	550	(55,727)	662,732
Residential mortgage-backed securities	59,936	735	(584)	60,087
Collateralized mortgage obligations	124,502	349	(4,390)	120,461
Corporate debt securities	72,376	4,610	(378)	76,608
States and political subdivisions	162,955	388	(6,508)	156,835
Commercial mortgage-backed securities	691	69		760
Equity securities	20,067	2,012		22,079
Note receivable	42,674	5,235		47,909
Warrant	12,068	76		12,144
Totals	\$ 1,256,862	\$ 14,106	\$ (67,825)	\$ 1,203,143

September 30, 2014	Amortized Cost	Held to Maturity		Fair Value
		Unrealized Gains	Unrealized Losses	
U.S. Treasury securities	\$ 25,010	\$	\$ (1)	\$ 25,009
U.S. government agencies:				
Residential mortgage-backed securities	30,183	275		30,458

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Collateralized mortgage obligations	58,825		(528)	58,297
States and political subdivisions	6,121	30	(14)	6,137
Totals	\$ 120,139	\$ 305	\$ (543)	\$ 119,901

Available for sale securities included 1,475,387 shares of SWS common stock, a \$50.0 million aggregate principal amount note issued by SWS and a warrant to purchase 8,695,652 shares of SWS common stock (the SWS Warrant ). SWS issued the note in July 2011 under a credit agreement pursuant to a senior unsecured loan from Hilltop. The note bore interest at a rate of 8.0% per annum, was prepayable by SWS subject to certain conditions after three years, and had a maturity of five years. The SWS Warrant provided for the purchase of 8,695,652 shares of SWS common stock at an exercise price of \$5.75 per share, subject to anti-dilution adjustments. On October 2, 2014, as discussed in Note 23 to the consolidated financial statements, Hilltop exercised the SWS Warrant in full and paid the aggregate exercise price by the

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

automatic elimination of the \$50.0 million aggregate principal amount note due to Hilltop under the credit agreement. Consequently, Hilltop beneficially owned approximately 21% of the outstanding shares of SWS common stock as of October 4, 2014.

Information regarding securities that were in an unrealized loss position is shown in the following tables (dollars in thousands).

	September 30, 2014			December 31, 2013		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
<b>Available for Sale</b>						
U.S. treasury securities:						
Unrealized loss for less than twelve months	4	\$ 7,378	\$ 52	6	\$ 12,748	\$ 238
Unrealized loss for twelve months or longer	2	2,005	12			
	6	9,383	64	6	12,748	238
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	5	64,792	208	35	526,817	45,274
Unrealized loss for twelve months or longer	27	439,772	18,314	5	90,931	10,453
	32	504,564	18,522	40	617,748	55,727
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months				2	2,194	54
Unrealized loss for twelve months or longer	4	10,870	401	3	9,309	530
	4	10,870	401	5	11,503	584
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	1	10,915	69	7	84,054	4,320
Unrealized loss for twelve months or longer	8	63,839	4,024	2	4,995	70
	9	74,754	4,093	9	89,049	4,390
Corporate debt securities:						
Unrealized loss for less than twelve months	4	4,837	21	7	10,754	378
Unrealized loss for twelve months or longer	1	1,891	107			
	5	6,728	128	7	10,754	378
States and political subdivisions:						
	1	500		46	30,245	669

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Unrealized loss for less than twelve months						
Unrealized loss for twelve months or longer	96	64,343	1,007	150	96,882	5,839
	97	64,843	1,007	196	127,127	6,508
<b>Warrants:</b>						
Unrealized loss for less than twelve months	1	11,434	634			
Unrealized loss for twelve months or longer	1	11,434	634			
<b>Total available for sale:</b>						
Unrealized loss for less than twelve months	16	99,856	984	103	666,812	50,933
Unrealized loss for twelve months or longer	138	582,720	23,865	160	202,117	16,892
	154	\$ 682,576	\$ 24,849	263	\$ 868,929	\$ 67,825

	September 30, 2014			December 31, 2013		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
<b><u>Held to Maturity</u></b>						
U.S. treasury securities:						
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	1	\$ 25,009	\$ 1		\$	\$
Unrealized loss for twelve months or longer	1	25,009	1			
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	2	58,297	528			
Unrealized loss for twelve months or longer	2	58,297	528			
States and political subdivisions:						
Unrealized loss for less than twelve months	6	3,411	14			
Unrealized loss for twelve months or longer	6	3,411	14			
<b>Total held to maturity:</b>						
Unrealized loss for less than twelve months	9	86,717	543			
Unrealized loss for twelve months or longer	9	\$ 86,717	\$ 543		\$	\$

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

During the three and nine months ended September 30, 2014 and 2013, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, the Company's analysis and experience indicate that these available for sale investments generally do not present a significant risk of other-than-temporary-impairment, as fair value should recover over time. Factors considered in the Company's analysis include 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 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. Therefore, management does not believe any other-than-temporary impairments exist at September 30, 2014.

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The amortized cost and fair value of securities, excluding trading and available for sale equity securities and the available for sale SWS Warrant, at September 30, 2014 are shown by contractual maturity below (in thousands).

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 122,236	\$ 122,520	\$ 25,010	\$ 25,009
Due after one year through five years	116,726	125,768	1,203	1,203
Due after five years through ten years	65,790	67,928	4,918	4,934
Due after ten years	659,425	641,825	31,131	31,146
	964,177	958,041		
Residential mortgage-backed securities	53,780	55,005	30,183	30,458
Collateralized mortgage obligations	100,938	96,982	58,825	58,297
Commercial mortgage-backed securities	596	656		
	\$ 1,119,491	\$ 1,110,684	\$ 120,139	\$ 119,901

The Company realized net gains from its trading securities portfolio of \$0.2 million and \$1.6 million during the three and nine months ended September 30, 2014, respectively, and a net gain of \$0.1 million and a net loss of \$2.6 million during the three and nine months ended September 30, 2013, respectively, which are recorded as a component of other noninterest income within the consolidated statements of operations.

Securities with a carrying amount of \$910.2 million and \$1.0 billion (with a fair value of \$929.3 million and \$938.1 million, respectively) at September 30, 2014 and December 31, 2013, were pledged to secure public and trust deposits, federal funds purchased and securities sold under agreements to repurchase, and for other purposes as required or permitted by law.

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Mortgage-backed securities and collateralized mortgage obligations consist principally of Government National Mortgage Association ( GNMA ), Federal National Mortgage Association ( FNMA ) and Federal Home Loan Mortgage Corporation ( FHLMC ) pass-through and participation certificates. GNMA securities are guaranteed by the full faith and credit of the United States, while FNMA and FHLMC securities are fully guaranteed by those respective United States government-sponsored agencies, and conditionally guaranteed by the full faith and credit of the United States.

At September 30, 2014 and December 31, 2013, NLC had investments on deposit in custody for various state insurance departments with carrying values of \$9.3 million and \$9.4 million, respectively.

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

**5. Non-Covered Loans and Allowance for Non-Covered Loan Losses**

Non-covered loans refer to loans not covered by the FDIC loss-share agreements. Covered loans are discussed in Note 6 to the consolidated financial statements. Non-covered loans summarized by portfolio segment are as follows (in thousands).

	September 30, 2014	December 31, 2013
Commercial and industrial	\$ 1,677,389	\$ 1,637,266
Real estate	1,606,718	1,457,253
Construction and land development	429,216	364,551
Consumer	55,520	55,576
	3,768,843	3,514,646
Allowance for non-covered loan losses	(39,027)	(33,241)
Total non-covered loans, net of allowance	\$ 3,729,816	\$ 3,481,405

The Bank has lending policies in place with the goal of establishing an asset portfolio that will provide a return on stockholders' equity sufficient to maintain capital to assets ratios that meet or exceed established regulations. Loans are underwritten with careful consideration of the borrower's financial condition, the specific purpose of the loan, the primary sources of repayment and any collateral pledged to secure the loan.

Underwriting procedures address financial components based on the size or complexity of the credit. The financial components include, but are not limited to, current and projected cash flows, shock analysis and/or stress testing, and trends in appropriate balance sheet and statement of operations ratios. Collateral analysis includes a complete description of the collateral, as well as determining values, monitoring requirements, loan to value ratios, concentration risk, appraisal requirements and other information relevant to the collateral being pledged. Guarantor analysis includes liquidity and cash flow analysis based on the significance the guarantors are expected to serve as secondary repayment sources. The Bank's underwriting standards are governed by adherence to its loan policy. The loan policy provides for specific guidelines by portfolio segment, including commercial and industrial, real estate, construction and land development, and consumer loans. Within each individual portfolio segment, permissible and impermissible loan types are explicitly outlined. Within the loan types, minimum requirements for the underwriting factors listed above are provided.

The Bank maintains a loan review department that reviews credit risk in response to both external and internal factors that potentially impact the performance of either individual loans or the overall loan portfolio. The loan review process reviews the creditworthiness of borrowers and determines compliance with the loan policy. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel. Results of these reviews are presented to management and the Bank's board of directors.

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In connection with the PlainsCapital Merger and the FNB Transaction, the Company acquired non-covered loans both with and without evidence of credit quality deterioration since origination. The following table presents the carrying values and the outstanding balances of the non-covered PCI loans (in thousands).

	September 30, 2014	December 31, 2013
Carrying amount	\$ 53,383	\$ 100,392
Outstanding balance	73,787	141,983

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Changes in the accretable yield for the non-covered PCI loans were as follows (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 11,904	\$ 20,118	\$ 17,601	\$ 17,553
Additions		1,923		1,923
Increases in expected cash flows	4,270	4,697	13,886	16,834
Disposals of loans	(744)	(441)	(4,928)	(2,273)
Accretion	(2,199)	(4,854)	(13,328)	(12,594)
Balance, end of period	\$ 13,231	\$ 21,443	\$ 13,231	\$ 21,443

The remaining nonaccretable difference for non-covered PCI loans was \$19.4 million and \$38.6 million at September 30, 2014 and December 31, 2013, respectively.

Impaired loans exhibit a clear indication that the borrower's cash flow may not be sufficient to meet principal and interest payments, which is generally when a loan is 90 days past due unless the asset is both well secured and in the process of collection.

Non-covered impaired loans include non-accrual loans, troubled debt restructurings ( TDRs ), PCI loans and partially charged-off loans. The amounts shown in following tables include loans accounted for on an individual basis, as well as acquired loans accounted for in pools ( Pooled Loans ). For Pooled Loans, the recorded investment with allowance and the related allowance consider impairment measured at the pool level. Non-covered impaired loans are summarized by class in the following tables (in thousands).

September 30, 2014	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
Commercial and industrial:					
Secured	\$ 50,070	\$ 12,966	\$ 12,253	\$ 25,219	\$ 3,406
Unsecured	4,334	286		286	
Real estate:					
Secured by commercial properties	30,202	4,490	18,537	23,027	1,659
Secured by residential properties	4,893	1,932	1,192	3,124	59
Construction and land development:					
Residential construction loans					
Commercial construction loans and land development	17,163	9,032	1,450	10,482	164
Consumer	6,354	317	2,338	2,655	421
	\$ 113,016	\$ 29,023	\$ 35,770	\$ 64,793	\$ 5,709

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<b>December 31, 2013</b>	<b>Unpaid Contractual Principal Balance</b>	<b>Recorded Investment with No Allowance</b>	<b>Recorded Investment with Allowance</b>	<b>Total Recorded Investment</b>	<b>Related Allowance</b>
<b>Commercial and industrial:</b>					
Secured	\$ 63,636	\$ 21,540	\$ 17,147	\$ 38,687	\$ 3,126
Unsecured	11,865	336	1,204	1,540	15
<b>Real estate:</b>					
Secured by commercial properties	49,437	20,317	16,070	36,387	339
Secured by residential properties	5,407	1,745	1,648	3,393	39
<b>Construction and land development:</b>					
Residential construction loans	33				
Commercial construction loans and land development	48,628	15,337	4,592	19,929	39
Consumer	7,946	4,509		4,509	
	\$ 186,952	\$ 63,784	\$ 40,661	\$ 104,445	\$ 3,558

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

Average investment in non-covered impaired loans is summarized by class in the following table (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Commercial and industrial:				
Secured	\$ 24,897	\$ 55,797	\$ 31,953	\$ 62,399
Unsecured	395	1,826	913	2,548
Real estate:				
Secured by commercial properties	23,715	45,114	29,707	48,798
Secured by residential properties	3,611	5,400	3,259	5,682
Construction and land development:				
Residential construction loans				354
Commercial construction loans and land development	10,674	25,916	15,206	28,502
Consumer	2,872	4,715	3,582	4,720
	\$ 66,164	\$ 138,768	\$ 84,620	\$ 153,003

Non-covered non-accrual loans, excluding those classified as held for sale, are summarized by class in the following table (in thousands).

	September 30,	December 31,
	2014	2013
Commercial and industrial:		
Secured	\$ 17,050	\$ 15,430
Unsecured	286	1,300
Real estate:		
Secured by commercial properties	464	2,638
Secured by residential properties	1,269	398
Construction and land development:		
Residential construction loans		
Commercial construction loans and land development	783	112
Consumer		
	\$ 19,852	\$ 19,878

At September 30, 2014 and December 31, 2013, non-covered non-accrual loans included non-covered PCI loans of \$8.5 million and \$15.8 million, respectively, for which discount accretion has been suspended because the extent and timing of cash flows from these non-covered PCI loans can no longer be reasonably estimated. In addition to the non-covered non-accrual loans in the table above, \$4.4 million and \$3.5 million of real estate loans secured by residential properties and classified as held for sale were in non-accrual status at September 30, 2014 and December 31, 2013, respectively.

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Interest income recorded on non-covered accruing impaired loans and on non-covered non-accrual loans was \$0.1 million and \$2.6 million for the three and nine months ended September 30, 2014, respectively. Interest income recorded on non-covered accruing impaired loans and on non-covered non-accrual loans for the three and nine months ended September 30, 2013 was nominal.

The Bank classifies loan modifications as TDRs when it concludes that it has both granted a concession to a debtor and that the debtor is experiencing financial difficulties. Loan modifications are typically structured to create affordable payments for the debtor and can be achieved in a variety of ways. The Bank modifies loans by reducing interest rates and/or lengthening loan amortization schedules. The Bank also reconfigures a single loan into two or more loans ( A/B Note ). The typical A/B Note restructure results in a bad loan which is charged off and a good loan or loans the terms

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(Unaudited)

of which comply with the Bank's customary underwriting policies. The debt charged off on the bad loan is not forgiven to the debtor.

Information regarding TDRs granted is shown in the following tables (in thousands). There were no TDRs granted for the three months ended September 30, 2014. At September 30, 2014, the Bank had no unadvanced commitments to borrowers whose loans have been restructured in TDRs. At December 31, 2013, the Bank had \$0.5 million in such unadvanced commitments.

Nine months ended September 30, 2014	A/B Note	Recorded Investment in Loans Modified by		Total Modification
		Interest Rate Adjustment	Payment Term Extension	
Commercial and industrial:				
Secured	\$	\$	\$	\$
Unsecured				
Real estate:				
Secured by commercial properties			326	326
Secured by residential properties			253	253
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development			133	133
Consumer	\$	\$	\$	\$
			712	712

Three months ended September 30, 2013	A/B Note	Recorded Investment in Loans Modified by		Total Modification
		Interest Rate Adjustment	Payment Term Extension	
Commercial and industrial:				
Secured	\$	\$	\$	\$
Unsecured				
Real estate:				
Secured by commercial properties				
Secured by residential properties				
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development				
Consumer	\$	\$	\$	\$
			333	333

Nine months ended September 30, 2013	A/B Note	Recorded Investment in Loans Modified by		Total Modification
		Interest Rate Adjustment	Payment Term Extension	

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Commercial and industrial:					
Secured	\$	\$	\$	9,764	\$ 9,764
Unsecured					
Real estate:					
Secured by commercial properties				276	276
Secured by residential properties				905	905
Construction and land development:					
Residential construction loans					
Commercial construction loans and land development				500	500
Consumer					
	\$	\$	\$	11,445	\$ 11,445

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(Unaudited)

There were no TDRs granted in the twelve months preceding September 30, 2014 and 2013, for which a payment was at least 30 days past due in the three and nine months ended September 30, 2014 and 2013, respectively.

An analysis of the aging of the Bank's non-covered loan portfolio is shown in the following tables (in thousands).

September 30, 2014	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans Past Due 90 Days or More
Commercial and industrial:								
Secured	\$ 4,285	\$ 868	\$ 7,910	\$ 13,063	\$ 1,541,305	\$ 16,335	\$ 1,570,703	\$
Unsecured	155	33		188	106,316	182	106,686	
Real estate:								
Secured by commercial properties								
	289			289	1,101,362	22,563	1,124,214	
Secured by residential properties								
	1,396	72	49	1,517	479,037	1,950	482,504	
Construction and land development:								
Residential construction loans								
					64,288		64,288	
Commercial construction loans and land development								
	49		650	699	354,531	9,698	364,928	
Consumer								
	206	40		246	52,619	2,655	55,520	
	\$ 6,380	\$ 1,013	\$ 8,609	\$ 16,002	\$ 3,699,458	\$ 53,383	\$ 3,768,843	\$

December 31, 2013	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans Past Due 90 Days or More
Commercial and industrial:								
Secured	\$ 2,171	\$ 277	\$ 1,354	\$ 3,802	\$ 1,492,793	\$ 35,372	\$ 1,531,967	\$ 272
Unsecured	333	9	60	402	103,453	1,444	105,299	59
Real estate:								
Secured by commercial properties								
	192		132	324	1,044,437	36,255	1,081,016	
Secured by residential properties								
	1,045	36	203	1,284	371,958	2,995	376,237	203

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Construction and land development:									
Residential construction loans	415			415	64,664			65,079	
Commercial construction loans and land development									
	41	881	112	1,034	278,621	19,817	299,472		
Consumer	201	60		261	50,806	4,509	55,576		
	\$ 4,398	\$ 1,263	\$ 1,861	\$ 7,522	\$ 3,406,732	\$ 100,392	\$ 3,514,646	\$ 534	

Management tracks credit quality trends on a quarterly basis related to: (i) past due levels, (ii) non-performing asset levels, (iii) classified loan levels, (iv) net charge-offs, and (v) general economic conditions in the state and local markets.

The Bank utilizes a risk grading matrix to assign a risk grade to each of the loans in its portfolio. A risk rating is assigned based on an assessment of the borrower's management, collateral position, financial capacity, and economic factors. The general characteristics of the various risk grades are described below.

**Pass** Pass loans present a range of acceptable risks to the Bank. Loans that would be considered virtually risk-free are rated Pass low risk. Loans that exhibit sound standards based on the grading factors above and present a reasonable risk to the Bank are rated Pass normal risk. Loans that exhibit a minor weakness in one or more of the grading criteria but still present an acceptable risk to the Bank are rated Pass high risk.

**Special Mention** Special Mention loans have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in a deterioration of the repayment prospects for the loans and weaken the Bank's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Bank to sufficient risk to require adverse classification.

**Substandard** Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Many substandard loans are considered impaired.

**PCI** PCI loans exhibited evidence of credit deterioration at acquisition that made it probable that all contractually required principal payments would not be collected.

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The following tables present the internal risk grades of non-covered loans, as previously described, in the portfolio by class (in thousands).

<b>September 30, 2014</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>PCI</b>	<b>Total</b>
<b>Commercial and industrial:</b>					
Secured	\$ 1,518,321	\$ 2,967	\$ 33,080	\$ 16,335	\$ 1,570,703
Unsecured	106,400		104	182	106,686
<b>Real estate:</b>					
Secured by commercial properties	1,097,637	717	3,297	22,563	1,124,214
Secured by residential properties	475,967		4,587	1,950	482,504
<b>Construction and land development:</b>					
Residential construction loans	64,288				64,288
Commercial construction loans and land development	353,782		1,448	9,698	364,928
Consumer	52,814		51	2,655	55,520
	\$ 3,669,209	\$ 3,684	\$ 42,567	\$ 53,383	\$ 3,768,843

<b>December 31, 2013</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>PCI</b>	<b>Total</b>
<b>Commercial and industrial:</b>					
Secured	\$ 1,450,734	\$ 16,840	\$ 29,021	\$ 35,372	\$ 1,531,967
Unsecured	103,674	12	169	1,444	105,299
<b>Real estate:</b>					
Secured by commercial properties	1,038,930	4,436	1,395	36,255	1,081,016
Secured by residential properties	367,758		5,484	2,995	376,237
<b>Construction and land development:</b>					
Residential construction loans	65,079				65,079
Commercial construction loans and land development	275,808	3,384	463	19,817	299,472
Consumer	51,052	1	14	4,509	55,576
	\$ 3,353,035	\$ 24,673	\$ 36,546	\$ 100,392	\$ 3,514,646

**Allowance for Loan Losses**

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses inherent in the existing portfolio of loans. Management has responsibility for determining the level of the allowance for loan losses, subject to review by the Audit Committee of the Company's Board of Directors and the Loan Review Committee of the Bank's board of directors.

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It is management's responsibility at the end of each quarter, or more frequently as deemed necessary, to analyze the level of the allowance for loan losses to ensure that it is appropriate for the estimated credit losses in the portfolio consistent with the Interagency Policy Statement on the Allowance for Loan and Lease Losses and the Receivables and Contingencies Topics of the ASC. Estimated credit losses are the probable current amount of loans that the Company will be unable to collect given facts and circumstances as of the evaluation date. When management determines that a loan or portion thereof is uncollectible, the loan, or portion thereof, is charged off against the allowance for loan losses, or for acquired loans accounted for in pools, charged against the pool discount. Recoveries on charge-offs that occurred prior to the PlainsCapital Merger represent contractual cash flows not expected to be collected and are recorded as accretion income. Recoveries on loans charged-off subsequent to the PlainsCapital Merger are credited to the allowance for loan loss, except for recoveries on loans accounted for in pools, which are credited to the pool discount. The Bank's loan portfolio is designated into two populations: acquired loans and originated loans. The allowance for loan losses is calculated separately for acquired and originated loans.

### *Originated Loans*

The Company has developed a methodology that seeks to determine an allowance within the scope of the Receivables and Contingencies Topics of the ASC. Each of the loans that has been determined to be impaired is within the scope of the Receivables Topic. Impaired loans that are equal to or greater than \$0.5 million are individually evaluated for impairment using one of three impairment measurement methods as of the evaluation date: (1) the present value of expected future discounted cash flows on the loan, (2) the loan's observable market price, or (3) the fair value of the collateral if the loan

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(Unaudited)

is collateral dependent. Specific reserves are provided in the estimate of the allowance based on the measurement of impairment under these three methods, except for collateral dependent loans, which require the fair value method. All non-impaired loans are within the scope of the Contingencies Topic. Estimates of loss for the Contingencies Topic are calculated based on historical loss, adjusted for qualitative or environmental factors. The Bank uses a rolling three year average net loss rate to calculate historical loss factors. The analysis is conducted by call report category, and further disaggregates commercial and industrial loans by collateral type. The analysis considers charge-offs and recoveries in determining the loss rate; therefore net charge-off experience is used. The historical loss calculation for the quarter is calculated by dividing the current quarter net charge-offs for each loan category by the quarter ended loan category balance. The Bank utilizes a weighted average loss rate to better represent recent trends. The Bank weights the most recent four quarter average at 120% versus the oldest four quarters at 80%.

While historical loss experience provides a reasonable starting point for the analysis, historical losses are not the sole basis upon which the Company determines the appropriate level for the allowance for loan losses. Management considers recent qualitative or environmental factors that are likely to cause estimated credit losses associated with the existing portfolio to differ from historical loss experience, including but not limited to:

- changes in the volume and severity of past due, nonaccrual and classified loans;
- changes in the nature, volume and terms of loans in the portfolio;
- changes in lending policies and procedures;
- changes in economic and business conditions and developments that affect the collectability of the portfolio;
- changes in lending management and staff;
- changes in the loan review system and the degree of oversight by the Bank's board of directors; and
- any concentrations of credit and changes in the level of such concentrations.

Changes in the volume and severity of past due, nonaccrual and classified loans, as well as changes in the nature, volume and terms of loans in the portfolio are key indicators of changes that could indicate a necessary adjustment to the historical loss factors. The magnitude of the impact of these factors on our qualitative assessment of the allowance for loan loss changes from quarter to quarter.

The loan review program is designed to identify and monitor problem loans by maintaining a credit grading process, requiring that timely and appropriate changes be made to reviewed loans and coordinating the delivery of the information necessary to assess the appropriateness of the

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allowance for loan losses. Loans are evaluated for impaired status when: (i) payments on the loan are delayed, typically by 90 days or more (unless the loan is both well secured and in the process of collection), (ii) the loan becomes classified, (iii) the loan is being reviewed in the normal course of the loan review scope, or (iv) the loan is identified by the servicing officer as a problem.

Homogeneous loans, such as consumer installment loans, residential mortgage loans and home equity loans, are not individually reviewed and are generally risk graded at the same levels. The risk grade and reserves are established for each homogeneous pool of loans based on the expected net charge-offs from current trends in delinquencies, losses or historical experience and general economic conditions. At September 30, 2014 and December 31, 2013, there were no material delinquencies in these types of loans.

### *Acquired Loans*

Loans acquired in a business combination are recorded at their estimated fair value on their purchase date and with no carryover of the related allowance for loan losses. Loans without evidence of credit impairment at acquisition are subsequently evaluated for any required allowance at each reporting date. An allowance for loan losses is calculated using a methodology similar to that described above for originated loans. The allowance as determined for each loan collateral type is compared to the remaining fair value discount for that loan collateral type. If greater, the excess is recognized as an addition to the allowance through a provision for loan losses. If less than the discount, no additional allowance is recorded. Charge-offs and losses first reduce any remaining fair value discount for the loan and once the discount is depleted, losses are applied against the allowance established for that loan.

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PCI loans acquired in the PlainsCapital Merger are accounted for on an individual loan basis, while PCI loans acquired in the FNB Transaction are accounted for both in pools and at the individual loan level. Cash flows expected to be collected are recast quarterly for each loan or pool. These evaluations require the continued use and updating of key assumptions and estimates such as default rates, loss severity given default and prepayment speed assumptions, similar to those used for the initial fair value estimate. Management judgment must be applied in developing these assumptions. If expected cash flows for a loan or pool decreases, an increase in the allowance for loan losses is made through a charge to the provision for loan losses. If expected cash flows for a loan or pool increase, any previously established allowance for loan losses is reversed and any remaining difference increases the accretable yield which will be taken into income over the remaining life of the loan.

The allowance for both originated and acquired loans is subject to regulatory examinations and determinations as to appropriateness, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance.

Changes in the allowance for non-covered loan losses, distributed by portfolio segment, are shown below (in thousands).

Three months ended September 30, 2014	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Balance, beginning of period	\$ 18,062	\$ 9,998	\$ 8,086	\$ 285	\$ 36,431
Provision charged to operations	2,302	1,064	395	425	4,186
Loans charged off	(1,976)	(28)		(116)	(2,120)
Recoveries on charged off loans	457	31	18	24	530
Balance, end of period	\$ 18,845	\$ 11,065	\$ 8,499	\$ 618	\$ 39,027

Nine months ended September 30, 2014	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Balance, beginning of period	\$ 16,865	\$ 8,331	\$ 7,957	\$ 88	\$ 33,241
Provision charged to operations	5,876	2,689	361	731	9,657
Loans charged off	(5,707)	(100)		(275)	(6,082)
Recoveries on charged off loans	1,811	145	181	74	2,211
Balance, end of period	\$ 18,845	\$ 11,065	\$ 8,499	\$ 618	\$ 39,027

Three months ended September 30, 2013	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Balance, beginning of period	\$ 13,806	\$ 5,339	\$ 7,050	\$ 42	\$ 26,237
Provision charged to operations	8,879	1,776	6	(3)	10,658
Loans charged off	(3,220)	(53)	(524)	(3)	(3,800)
Recoveries on charged off loans	42	26	2	15	85
Balance, end of period	\$ 19,507	\$ 7,088	\$ 6,534	\$ 51	\$ 33,180

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Nine months ended September 30, 2013	Commercial and		Construction and		Consumer	Total
	Industrial	Real Estate	Land Development			
Balance, beginning of period	\$ 1,845	\$ 977	\$ 582	\$ 5	\$ 3,409	
Provision charged to operations	22,519	6,033	6,323	77	34,952	
Loans charged off	(7,314)	(149)	(524)	(74)	(8,061)	
Recoveries on charged off loans	2,457	227	153	43	2,880	
Balance, end of period	\$ 19,507	\$ 7,088	\$ 6,534	\$ 51	\$ 33,180	

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The non-covered loan portfolio was distributed by portfolio segment and impairment methodology as shown below (in thousands).

<b>September 30, 2014</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$ 8,354	\$ 1,450	\$ 783	\$	\$ 10,587
Loans collectively evaluated for impairment	1,652,518	1,580,755	418,735	52,865	3,704,873
PCI Loans	16,517	24,513	9,698	2,655	53,383
	\$ 1,677,389	\$ 1,606,718	\$ 429,216	\$ 55,520	\$ 3,768,843

<b>December 31, 2013</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$ 2,273	\$ 373	\$ 112	\$	\$ 2,758
Loans collectively evaluated for impairment	1,598,177	1,417,630	344,622	51,067	3,411,496
PCI Loans	36,816	39,250	19,817	4,509	100,392
	\$ 1,637,266	\$ 1,457,253	\$ 364,551	\$ 55,576	\$ 3,514,646

The allowance for non-covered loan losses was distributed by portfolio segment and impairment methodology as shown below (in thousands).

<b>September 30, 2014</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$ 421	\$	\$	\$	\$ 421
Loans collectively evaluated for impairment	15,439	9,347	8,335	197	33,318
PCI Loans	2,985	1,718	164	421	5,288
	\$ 18,845	\$ 11,065	\$ 8,499	\$ 618	\$ 39,027

<b>December 31, 2013</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$ 421	\$	\$	\$	\$ 421
Loans collectively evaluated for impairment	13,724	7,953	7,918	88	29,683
PCI Loans	2,720	378	39		3,137
	\$ 16,865	\$ 8,331	\$ 7,957	\$ 88	\$ 33,241

**6. Covered Assets and Indemnification Asset**

As discussed in Note 2 to the consolidated financial statements, the Bank assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of FNB in an FDIC-assisted transaction on September 13, 2013. Pursuant to the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets: (i) 80% of losses on the first \$240.4 million of losses incurred; (ii) 0% of losses in excess of \$240.4 million up to and including \$365.7 million of losses incurred; and (iii) 80% of losses in excess of \$365.7 million of losses incurred. The Bank has also agreed to reimburse the FDIC for any subsequent recoveries. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date, and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. The asset arising from the loss-share agreements, which we refer to as the FDIC Indemnification Asset, is measured separately from the covered loan portfolio because the agreements are not contractually embedded in the covered loans and are not transferable should the Bank choose to dispose of the covered loans.

In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC's initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

*Covered Loans and Allowance for Covered Loan Losses*

Loans acquired in the FNB Transaction that are subject to a loss-share agreement are referred to as covered loans and reported separately in the consolidated balance sheets. Covered loans are reported exclusive of the cash flow reimbursements that may be received from the FDIC.

The Bank's portfolio of acquired covered loans had a fair value of \$1.1 billion as of the Bank Closing Date, with no carryover of any allowance for loan losses. Acquired covered loans were preliminarily segregated between those considered to be PCI loans and those without credit impairment at acquisition.

In connection with the FNB Transaction, the Bank acquired loans both with and without evidence of credit quality deterioration since origination. The Company's accounting policies for acquired covered loans, including covered PCI loans, are consistent with that of acquired non-covered loans, as described in Note 5 to the consolidated financial statements. The Company has established under its PCI accounting policy a framework to aggregate certain acquired covered loans into various loan pools based on a minimum of two layers of common risk characteristics for the purpose of determining their respective fair values as of their acquisition dates, and for applying the subsequent recognition and measurement provisions for income accretion and impairment testing.

The following table presents the carrying value of the covered loans summarized by portfolio segment (in thousands).

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Commercial and industrial	\$ 33,510	\$ 66,943
Real estate	637,297	787,982
Construction and land development	80,468	151,444
Consumer		
Total covered loans	751,275	1,006,369
Allowance for covered loans	(3,761)	(1,061)
Total covered loans, net of allowance	\$ 747,514	\$ 1,005,308

The following table presents the carrying value and the outstanding contractual balance of the covered PCI loans (in thousands).

<b>September 30, 2014</b>	<b>December 31, 2013</b>
-------------------------------	------------------------------

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Carrying amount	\$	527,748	\$	729,156
Outstanding balance		797,799		1,022,514

Changes in the accretable yield for the covered PCI loans were as follows (in thousands).

	<b>Three Months Ended September 30, 2014</b>		<b>Nine Months Ended September 30, 2014</b>	
Balance, beginning of period	\$	186,141	\$	156,548
Increases in expected cash flows		25,026		82,607
Transfer of loans to covered OREO		(281)		5,091
Accretion		(18,146)		(51,506)
Balance, end of period	\$	192,740	\$	192,740

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

The remaining nonaccretable difference for covered PCI loans was \$368.2 million and \$517.9 million at September 30, 2014 and December 31, 2013, respectively.

Covered impaired loans include non-accrual loans, TDRs, PCI loans and partially charged-off loans. Substantially all covered impaired loans are PCI loans. The amounts shown in following tables include Pooled Loans, as well as loans accounted for on an individual basis. For Pooled Loans, the recorded investment with allowance and the related allowance consider impairment measured at the pool level. Covered impaired loans are summarized by class in the following tables (in thousands).

<b>September 30, 2014</b>	<b>Unpaid Contractual Principal Balance</b>	<b>Recorded Investment with No Allowance</b>	<b>Recorded Investment with Allowance</b>	<b>Total Recorded Investment</b>	<b>Related Allowance</b>
<b>Commercial and industrial:</b>					
Secured	\$ 29,812	\$ 16,977	\$ 882	\$ 16,977	\$ 882
Unsecured	15,103	6,697	882	7,579	882
<b>Real estate:</b>					
Secured by commercial properties	444,761	225,555	53,890	279,445	1,208
Secured by residential properties	254,400	152,003	9,400	161,403	817
<b>Construction and land development:</b>					
Residential construction loans	3,060	1,637		1,637	
Commercial construction loans and land development	120,344	51,492	13,515	65,007	765
Consumer					
	\$ 867,480	\$ 454,361	\$ 77,687	\$ 532,048	\$ 3,672

<b>December 31, 2013</b>	<b>Unpaid Contractual Principal Balance</b>	<b>Recorded Investment with No Allowance</b>	<b>Recorded Investment with Allowance</b>	<b>Total Recorded Investment</b>	<b>Related Allowance</b>
<b>Commercial and industrial:</b>					
Secured	\$ 43,957	\$ 28,611	\$ 882	\$ 28,611	\$ 882
Unsecured	16,280	9,008	882	9,890	882
<b>Real estate:</b>					
Secured by commercial properties	528,825	365,346		365,346	
Secured by residential properties	289,094	199,581		199,581	
<b>Construction and land development:</b>					
Residential construction loans	8,920	5,280		5,280	
Commercial construction loans and land development	183,117	121,363		121,363	
Consumer					
	\$ 1,070,193	\$ 729,189	\$ 882	\$ 730,071	\$ 882

Average investment in covered impaired loans is summarized by class in the following table (in thousands).

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	<b>Three Months Ended September 30, 2014</b>	<b>Nine Months Ended September 30, 2014</b>
<b>Commercial and industrial:</b>		
Secured	\$ 17,953	\$ 22,794
Unsecured	7,994	8,735
<b>Real estate:</b>		
Secured by commercial properties	297,511	322,396
Secured by residential properties	168,636	180,492
<b>Construction and land development:</b>		
Residential construction loans	2,356	3,459
Commercial construction loans and land development	71,795	93,185
Consumer	\$ 566,245	\$ 631,061

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Covered non-accrual loans, excluding those classified as held for sale, are summarized by class in the following table (in thousands).

	September 30, 2014	December 31, 2013
Commercial and industrial:		
Secured	\$ 1,003	\$ 91
Unsecured	883	882
Real estate:		
Secured by commercial properties	36,237	40
Secured by residential properties	1,051	209
Construction and land development:		
Residential construction loans	1,102	575
Commercial construction loans and land development	14	
Consumer		
	\$ 40,290	\$ 1,797

At September 30, 2014, covered non-accrual loans included covered PCI loans of \$36.6 million for which discount accretion has been suspended because the extent and timing of cash flows from these covered PCI loans can no longer be reasonably estimated.

Interest income recorded on covered accruing impaired loans and on covered non-accrual loans for the three and nine months ended September 30, 2014 was nominal. Except as noted above, covered PCI loans are considered to be performing due to the application of the accretion method. Additionally, no acquired covered performing loans have been modified in a TDR.

An analysis of the aging of the Bank's covered loan portfolio is shown in the following tables (in thousands).

September 30, 2014	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans Past Due 90 Days or More
Commercial and industrial:								
Secured	\$ 3	\$ 11	\$ 993	\$ 1,007	\$ 7,428	\$ 15,963	\$ 24,398	\$ 11
Unsecured		97		97	1,436	7,579	9,112	
Real estate:								
Secured by commercial properties	396		105	501	51,704	278,959	331,164	
Secured by residential properties	1,437	608	880	2,925	143,478	159,730	306,133	519

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Construction and land development:								
Residential construction loans	219		994	1,213	547	535	2,295	
Commercial construction loans and land development								
	52	16	12	80	13,111	64,982	78,173	12
Consumer	\$ 2,107	\$ 732	\$ 2,984	\$ 5,823	\$ 217,704	\$ 527,748	\$ 751,275	\$ 542

December 31, 2013	Loans Past Due			Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans Past Due 90 Days or More
	30-59 Days	60-89 Days	90 Days or More					
Commercial and industrial:								
Secured	\$ 3,904	\$ 10	\$ 81	\$ 3,995	\$ 20,918	\$ 28,520	\$ 53,433	\$
Unsecured	10	259		269	3,351	9,890	13,510	
Real estate:								
Secured by commercial properties								
	999		40	1,039	63,780	365,306	430,125	
Secured by residential properties								
	1,679	678	209	2,566	155,919	199,372	357,857	
Construction and land development:								
Residential construction loans								
	1,861		576	2,437	5,026	4,705	12,168	
Commercial construction loans and land development								
	244	20		264	17,649	121,363	139,276	
Consumer	\$ 8,697	\$ 967	\$ 906	\$ 10,570	\$ 266,643	\$ 729,156	\$ 1,006,369	\$

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### Hilltop Holdings Inc. and Subsidiaries

#### Notes to Consolidated Financial Statements (continued)

(Unaudited)

The Bank assigns a risk grade to each of its covered loans in a manner consistent with the existing loan review program and risk grading matrix used for non-covered loans, as described in Note 5 to the consolidated financial statements. The following tables present the internal risk grades of covered loans in the portfolio by class (in thousands).

<b>September 30, 2014</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>PCI</b>	<b>Total</b>
<b>Commercial and industrial:</b>					
Secured	\$ 6,229	\$	\$ 2,206	\$ 15,963	\$ 24,398
Unsecured	1,309		224	7,579	9,112
<b>Real estate:</b>					
Secured by commercial properties	43,379		8,826	278,959	331,164
Secured by residential properties	138,612		7,791	159,730	306,133
<b>Construction and land development:</b>					
Residential construction loans	658		1,102	535	2,295
Commercial construction loans and land development	10,486		2,705	64,982	78,173
Consumer	\$ 200,673	\$	\$ 22,854	\$ 527,748	\$ 751,275

<b>December 31, 2013</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>PCI</b>	<b>Total</b>
<b>Commercial and industrial:</b>					
Secured	\$ 24,152	\$	\$ 761	\$ 28,520	\$ 53,433
Unsecured	3,040		580	9,890	13,510
<b>Real estate:</b>					
Secured by commercial properties	59,343	3,310	2,166	365,306	430,125
Secured by residential properties	155,439		3,046	199,372	357,857
<b>Construction and land development:</b>					
Residential construction loans	6,087		1,376	4,705	12,168
Commercial construction loans and land development	17,806		107	121,363	139,276
Consumer	\$ 265,867	\$ 3,310	\$ 8,036	\$ 729,156	\$ 1,006,369

The Bank's impairment methodology for the covered loans is consistent with that of non-covered loans as discussed in Note 5 to the consolidated financial statements. To the extent there is experienced or projected credit deterioration on the acquired covered loan pools subsequent to amounts estimated at the previous quarterly recast date and expected cash flows for a loan or pool decreases, an increase in the allowance for loan losses is made through a charge to the provision for loan losses. If expected cash flows for a loan or pool increase, any previously established allowance for loan losses is reversed and any remaining difference increases the accretable yield which will be taken into income over the remaining life of the loan. Additionally, provision for credit losses will be recorded on advances on covered loans subsequent to the acquisition date in a manner consistent with the allowance for non-covered loan losses.

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Changes in the allowance for covered loan losses, distributed by portfolio segment, are shown below (in thousands).

Three months ended September 30, 2014	Commercial and Industrial		Real Estate		Construction and Land Development		Consumer		Total
Balance, beginning of period	\$	1,146	\$	2,551	\$	418	\$	\$	4,115
Provision charged to operations		(211)		(342)		400			(153)
Loans charged off				(169)		(32)			(201)
Recoveries on charged off loans									
Balance, end of period	\$	935	\$	2,040	\$	786	\$	\$	3,761

Nine months ended September 30, 2014	Commercial and Industrial		Real Estate		Construction and Land Development		Consumer		Total
Balance, beginning of period	\$	1,053	\$	8	\$	\$	\$	\$	1,061
Provision charged to operations		(27)		2,245		933			3,151
Loans charged off		(91)		(213)		(147)			(451)
Recoveries on charged off loans									
Balance, end of period	\$	935	\$	2,040	\$	786	\$	\$	3,761

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The covered loan portfolio was distributed by portfolio segment and impairment methodology as shown below (in thousands).

<b>September 30, 2014</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$ 915	\$	\$ 801	\$	\$ 1,716
Loans collectively evaluated for impairment	9,053	198,608	14,150		221,811
PCI Loans	23,542	438,689	65,517		527,748
	\$ 33,510	\$ 637,297	\$ 80,468	\$	\$ 751,275

<b>December 31, 2013</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$	\$	\$	\$	\$
Loans collectively evaluated for impairment	28,533	223,304	25,376		277,213
PCI Loans	38,410	564,678	126,068		729,156
	\$ 66,943	\$ 787,982	\$ 151,444	\$	\$ 1,006,369

The allowance for covered loan losses was distributed by portfolio segment and impairment methodology as shown below (in thousands).

<b>September 30, 2014</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$	\$	\$	\$	\$
Loans collectively evaluated for impairment	53	15	21		89
PCI Loans	882	2,025	765		3,672
	\$ 935	\$ 2,040	\$ 786	\$	\$ 3,761

<b>December 31, 2013</b>	<b>Commercial and Industrial</b>	<b>Real Estate</b>	<b>Construction and Land Development</b>	<b>Consumer</b>	<b>Total</b>
Loans individually evaluated for impairment	\$	\$	\$	\$	\$
Loans collectively evaluated for impairment	171	8			179
PCI Loans	882				882
	\$ 1,053	\$ 8	\$	\$	\$ 1,061

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*Covered Other Real Estate Owned*

A summary of the activity in covered OREO is as follows (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 142,174	\$	\$ 142,833	\$
Fair value of assets acquired as of Bank Closing Date		135,187		135,187
Additions to covered OREO	10,214		42,206	
Dispositions of covered OREO	(11,150)	(1,326)	(40,842)	(1,326)
Valuation adjustments in the period	(14,440)		(17,399)	
Balance, end of period	\$ 126,798	\$ 133,861	\$ 126,798	\$ 133,861

During the three and nine months ended September 30, 2014, the Bank wrote down certain covered OREO assets to fair value to reflect new appraisals on certain OREO acquired in the FNB Transaction and OREO acquired from the foreclosure on certain FNB loans acquired in the FNB Transaction. Although the Bank recorded a fair value discount on the acquired assets upon acquisition, in some cases additional downward valuations were required.

These additional downward valuation adjustments reflect changes to the assumptions regarding the fair value of the OREO, including in some cases the intended use of the OREO due to the availability of more information as well as the passage of time. The process of determining fair value is subjective in nature and requires the use of significant estimates and assumptions. Although the Bank makes market-based assumptions when valuing acquired assets, new information may come to light that causes estimates to increase or decrease. When the Bank determines, based on subsequent information, that its

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

estimates require adjustment, the Bank records the adjustment. The accounting for such adjustments requires that the decreases to fair value be recorded at the time such new information is received, while increases to fair value are recorded when the asset is subsequently sold. All of the impairments recorded during the three months ended September 30, 2014 related to covered assets subject to the loss-share agreements with the FDIC.

*FDIC Indemnification Asset*

A summary of the activity in the FDIC Indemnification Asset is as follows (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 175,114	\$	\$ 188,291	\$
Fair value of assets acquired as of Bank Closing Date		185,680		185,680
FDIC Indemnification Asset accretion (amortization)	825	291	2,672	291
Transfers to due from FDIC and other	(26,151)		(41,175)	
Balance, end of period	\$ 149,788	\$ 185,971	\$ 149,788	\$ 185,971

**7. Mortgage Servicing Rights**

The following tables present the changes in fair value of the Company's MSR and other information related to our serviced portfolio (dollars in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 35,877	\$ 7,111	\$ 20,149	\$ 2,080
Additions	18,982	4,079	33,790	8,384
Sales	(11,387)		(11,387)	
Changes in fair value:				
Due to changes in model inputs or assumptions (1)	(1,024)	2,377	627	3,284
Due to customer payments	(541)	(166)	(1,272)	(347)
Balance, end of period	\$ 41,907	\$ 13,401	\$ 41,907	\$ 13,401

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	September 30, 2014	December 31, 2013
Mortgage loans serviced for others	\$ 3,657,999	\$ 1,965,883
MSR as a percentage of serviced mortgage loans	1.15%	1.02%

---

(1) Primarily represents changes in discount rates and prepayment speed assumptions, which are primarily affected by changes in interest rates and the refinement of other MSR model assumptions.

The key assumptions used in measuring the fair value of the Company's MSR were as follows.

	September 30, 2014	December 31, 2013
Weighted average constant prepayment rate	9.51%	9.72%
Weighted average discount rate	11.03%	12.37%
Weighted average life (in years)	7.6	7.6

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

A sensitivity analysis of the fair value of the Company's MSR to certain key assumptions is presented in the following table (in thousands).

	September 30, 2014	December 31, 2013
Constant prepayment rate:		
Impact of 10% adverse change	\$ (1,556)	\$ (601)
Impact of 20% adverse change	(3,009)	(1,170)
Discount rate:		
Impact of 100 basis point adverse change	(1,835)	(631)
Impact of 200 basis point adverse change	(3,519)	(1,236)

This sensitivity analysis presents the effect of hypothetical changes in key assumptions on the fair value of the MSR. The effect of such hypothetical change in assumptions generally cannot be extrapolated because the relationship of the change in one key assumption to the change in the fair value of the MSR is not linear. In addition, in the analysis, the impact of an adverse change in one key assumption is calculated independent of any impact on other assumptions. In reality, changes in one assumption may change another assumption.

Contractually specified servicing fees, late fees and ancillary fees earned of \$3.1 million and \$0.9 million during the three months ended September 30, 2014 and 2013, respectively, and \$8.1 million and \$1.8 million during the nine months ended September 30, 2014 and 2013, respectively, were included in other noninterest income within the consolidated statements of operations.

**8. Deposits**

Deposits are summarized as follows (in thousands).

	September 30, 2014	December 31, 2013
Noninterest-bearing demand	\$ 1,988,066	\$ 1,773,749
Interest-bearing:		
NOW accounts	1,112,749	1,083,596
Money market	865,144	878,578
Brokered - money market	96,632	276,760
Demand	108,701	47,636
Savings	343,667	357,325
Time	1,631,765	2,110,947

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Brokered - time	89,558	194,327
	\$ 6,236,282	\$ 6,722,918

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

**9. Short-term Borrowings**

Short-term borrowings are summarized as follows (in thousands).

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Federal funds purchased	\$ 121,050	\$ 137,225
Securities sold under agreements to repurchase	134,134	107,462
Federal Home Loan Bank notes	525,000	
Short-term bank loans	65,800	97,400
	<b>\$ 845,984</b>	<b>\$ 342,087</b>

Federal funds purchased and securities sold under agreements to repurchase generally mature daily, on demand, or on some other short-term basis. The Bank and FSC execute transactions to sell securities under agreements to repurchase with both customers and broker-dealers. Securities involved in these transactions are held by the Bank, FSC or the dealer.

Information concerning federal funds purchased and securities sold under agreements to repurchase is shown in the following tables (dollars in thousands).

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
Average balance during the period	\$ 326,936	\$ 284,819
Average interest rate during the period	0.17%	0.19%

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Average interest rate at end of period	0.14%	0.16%
Securities underlying the agreements at end of period:		
Carrying value	\$ 179,921	\$ 144,991
Estimated fair value	\$ 175,835	\$ 138,719

Federal Home Loan Bank ( FHLB ) notes mature over terms not exceeding 365 days and are collateralized by FHLB Dallas stock, nonspecified real estate loans and certain specific commercial real estate loans. Other information regarding FHLB notes is shown in the following tables (dollars in thousands).

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	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
Average balance during the period	\$ 258,849	\$ 142,274
Average interest rate during the period	0.17%	0.13%

	<b>September 30,</b>	<b>December 31,</b>
	<b>2014</b>	<b>2013</b>
Average interest rate at end of period	0.17%	

FSC uses short-term bank loans periodically to finance securities owned, margin loans to customers and correspondents, and underwriting activities. Interest on the borrowings varies with the federal funds rate. The weighted average interest rate on the borrowings at September 30, 2014 and December 31, 2013 was 1.06% and 1.15%, respectively.

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

**10. Income Taxes**

The Company applies an estimated annual effective rate to interim period pre-tax income to calculate the income tax provision for the quarter in accordance with the principal method prescribed by the accounting guidance established for computing income taxes in interim periods. The Company's effective rate was 35.8% and 33.7% for the three months ended September 30, 2014 and 2013, respectively, and 36.1% and 35.5% for the nine months ended September 30, 2014 and 2013, respectively.

GAAP requires the measurement of uncertain tax positions. Uncertain tax positions are the difference between a tax position taken, or expected to be taken in a tax return, and the benefit recognized for accounting purposes. There were no uncertain tax positions at September 30, 2014 or December 31, 2013.

The Company files income tax returns in U.S. federal and several state jurisdictions. The Company is subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitations expires. The Company is no longer subject to U.S. federal tax examinations for tax years prior to 2011. The Company is open for various state tax audits for tax years 2010 and later. The Company has been notified of income tax examinations by several state authorities for tax years 2010, 2011 and 2012. The Company does not expect any significant liability to arise as a result of the examinations.

**11. Commitments and Contingencies**

*Legal Matters*

The Company is subject to loss contingencies related to litigation, claims, investigations and legal and administrative cases and proceedings arising in the ordinary course of business. The Company evaluates these contingencies based on information currently available, including advice of counsel. The Company establishes accruals for those matters when a loss contingency is considered probable and the related amount is reasonably estimable. Any accruals are periodically reviewed and may be adjusted as circumstances change. Some of the Company's exposure with respect to loss contingencies may be offset by applicable insurance coverage. In determining the amounts of any accruals or estimates of possible loss contingencies however, the Company does not take into account the availability of insurance coverage. When it is practicable, the Company estimates loss contingencies for possible litigation and claims, whether or not there is an accrued probable loss. When the Company is able to estimate such possible losses, and when it estimates that it is reasonably possible it could incur losses, in excess of amounts accrued, the Company is required to make a disclosure of the aggregate estimation. However, as available information changes, the matters for which the Company is able to estimate, as well as the estimates themselves will be adjusted, accordingly.

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Assessments of litigation and claims exposures are difficult due to many factors that involve inherent unpredictability. Those factors include the following: the varying stages of the proceedings, particularly in the early stages; unspecified, unsupported, or uncertain damages; damages other than compensatory, such as punitive damages; a matter presenting meaningful legal uncertainties, including novel issues of law; multiple defendants and jurisdictions; whether discovery has begun or not or discovery is not complete; meaningful settlement discussions have not commenced; and whether the claim involves a class action and if so, how the class is defined. As a result of some of these factors, the Company may be unable to estimate reasonably possible losses with respect to some or all of the pending and threatened litigation and claims asserted against the Company.

Each of Hilltop, Peruna LLC (wholly owned subsidiary of Hilltop), SWS and the individual members of the board of directors of SWS have been named as defendants in two purported stockholder class action lawsuits arising out of the pending merger. Both lawsuits were filed in Delaware Chancery Court (*Joseph Arceri v. SWS Group, Inc. et al* and *Chaile Steinberg v. SWS Group, Inc. et al* filed April 8, 2014 and April 11, 2014, respectively). On May 13, 2014, the Delaware Chancery Court consolidated the two actions for all purposes. On June 10, 2014, plaintiffs filed a consolidated amended complaint. The complaint generally alleges, among other things, that the SWS board of directors breached its fiduciary duties to stockholders by failing to take steps to maximize stockholder value or to engage in a fair sale process before approving the merger, that the SWS board of directors labored under conflicts of interest, that certain provisions of the

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merger agreement unduly restrict SWS's ability to negotiate with other potential bidders, and that the other defendants aided and abetted the SWS board of director's breaches of fiduciary duty. The complaint further alleges, among other things, that the proxy statement/prospectus filed by Hilltop on May 29, 2014 omits or misstates certain material information. The complaints seek relief that includes, among other things, an injunction prohibiting the consummation of the merger, rescission to the extent the merger terms have already been implemented, damages for the alleged breaches of fiduciary duty, and the payment of plaintiffs' attorneys' fees and costs. On June 16, 2014, plaintiffs moved for a preliminary injunction prohibiting the consummation of the merger, and for expedited proceedings in connection therewith. Pursuant to negotiations between the parties to the lawsuit, plaintiffs subsequently withdrew those motions. Hilltop believes that the claims are without merit and intends to vigorously defend against these actions.

The Company is involved in information-gathering requests and investigations (both formal and informal), as well as reviews, examinations and proceedings (collectively, "Inquiries") by various governmental regulatory agencies, law enforcement authorities and self-regulatory bodies regarding its business, business practices and policies, as well as the conduct of persons with whom it does business. Additional Inquiries will arise from time to time. In connection with those Inquiries, the Company receives document requests, subpoenas and other requests for information. The Inquiries, including the Inquiry described below, could develop into administrative, civil or criminal proceedings or enforcement actions that could result in consequences that have a material effect on the Company's consolidated financial position, results of operations or cash flows as a whole. Such consequences could include adverse judgments, findings, settlements, penalties, fines, orders, injunctions, restitution, or alterations in the Company's business practices, and could result in additional expenses and collateral costs, including reputational damage.

As a part of an industry-wide inquiry, PrimeLending received a subpoena from the Office of Inspector General of the U.S. Department of Housing and Urban Development regarding mortgage-related practices, including those relating to origination practices for loans insured by the Federal Housing Administration (the "FHA"). On August 20, 2014, PrimeLending received a Civil Investigative Demand from the United States Department of Justice (the "DOJ") related to this Inquiry. According to the Civil Investigative Demand, the DOJ is conducting an investigation to determine whether PrimeLending has violated the False Claims Act in connection with originating and underwriting single-family residential mortgage loans insured by the FHA. PrimeLending is cooperating with the investigation and continues to respond to the Civil Investigative Demand.

While the final outcome of litigation and claims exposures or of any Inquiries is inherently unpredictable, management is currently of the opinion that the outcome of pending and threatened litigation and Inquiries will not have a material effect on the Company's business, consolidated financial position, results of operations or cash flows as a whole. However, in the event of unexpected future developments, it is reasonably possible that an adverse outcome in any of the matters discussed above could be material to the Company's business, consolidated financial position, results of operations or cash flows for any particular reporting period of occurrence.

*Other Contingencies*

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The mortgage origination segment may be responsible for errors or omissions relating to its representations and warranties that each loan sold meets certain requirements, including representations as to underwriting standards and the validity of certain borrower representations in connection with the loan. If determined to be at fault, the mortgage origination segment either repurchases the affected loan from the investor or reimburses the investor's losses. The mortgage origination segment has established an indemnification liability reserve for such probable losses.

Generally, the mortgage origination segment first becomes aware that an investor believes a loss has been incurred on a sold loan when it receives a written request from the investor to repurchase the loan or reimburse the investor's losses. Upon completing its review of the investor's request, the mortgage origination segment establishes a specific claims reserve for the loan if it concludes its obligation to the investor is both probable and reasonably estimable.

An additional reserve has been established for probable investor losses that may have been incurred, but not yet reported to the mortgage origination segment based upon a reasonable estimate of such losses. Factors considered in the calculation of this reserve include, but are not limited to, the total volume of loans sold exclusive of specific investor requests, actual investor claim settlements and the severity of estimated losses resulting from future claims, and the mortgage origination

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segment's history of successfully curing defects identified in investor claim requests. While the mortgage origination segment's sales contracts typically include borrower early payment default repurchase provisions, these provisions have not been a primary driver of investor claims to date, and therefore, are not a primary factor considered in the calculation of this reserve.

At September 30, 2014 and December 31, 2013, the mortgage origination segment's indemnification liability reserve totaled \$19.1 million and \$21.1 million, respectively. The provision for indemnification losses was \$0.9 million during the three months ended September 30, 2014 and 2013, respectively, and \$2.3 million and \$2.8 million during the nine months ended September 30, 2014 and 2013, respectively.

The following tables provide for a roll-forward of claims activity for loans put-back to the mortgage origination segment based upon an alleged breach of a representation or warranty with respect to a loan sold and related indemnification liability reserve activity (in thousands).

	Representation and Warranty Specific Claims Activity - Origination Loan Balance Three Months Ended September 30,		Representation and Warranty Specific Claims Activity - Origination Loan Balance Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 53,123	\$ 46,090	\$ 51,912	\$ 39,693
Claims made	13,336	6,769	35,179	26,423
Claims resolved with no payment	(8,329)	(2,338)	(17,660)	(10,751)
Repurchases	(3,173)	(1,597)	(12,411)	(4,496)
Indemnification payments	(1,168)	(542)	(3,231)	(2,487)
Balance, end of period	\$ 53,789	\$ 48,382	\$ 53,789	\$ 48,382

	Indemnification Liability Reserve Activity Three Months Ended September 30,		Indemnification Liability Reserve Activity Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance, beginning of period	\$ 19,688	\$ 20,397	\$ 21,121	\$ 18,964
Additions for new sales	883	878	2,295	2,834
Repurchases	(388)	(120)	(1,416)	(255)
Early payment defaults	(24)	(165)	(101)	(397)
Indemnification payments	(542)	(177)	(1,654)	(701)
Change in estimate	(508)	214	(1,136)	582
Balance, end of period	\$ 19,109	\$ 21,027	\$ 19,109	\$ 21,027

Reserve for Indemnification Liability:	
Specific claims	\$ 11,517
Incurred but not reported claims	7,592
Total	\$ 19,109

Although management considers the total indemnification liability reserve to be appropriate, there may be changes in the reserve over time to address incurred losses, due to unanticipated adverse changes in the economy and historical loss patterns, discrete events adversely affecting specific borrowers or industries, and/or actions taken by institutions or investors. The impact of such matters is considered in the reserving process when probable and estimable.

In connection with the FNB Transaction, the Bank entered into two loss-share agreements with the FDIC that collectively cover \$1.2 billion of loans and OREO acquired in the FNB Transaction. Pursuant to the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets: (i) 80% of losses on the first \$240.4 million of losses incurred; (ii) 0% of losses in excess of \$240.4 million up to and including \$365.7 million of losses incurred; and (iii) 80% of losses in excess of \$365.7 million of losses incurred. The Bank has also agreed to reimburse the FDIC for any subsequent recoveries. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC's initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement. As of September 30, 2014, the Bank estimated that covered losses and reimbursable expenses exceed \$240.4 million, but do not exceed \$365.7 million. Unless the estimates of covered losses and reimbursable expenses exceed \$365.7 million, the Bank will not record additional reimbursement receivable from the FDIC. As of September 30, 2014, the Bank had billed \$46.6 million of covered net losses to the FDIC, of which 80%, or \$37.7 million, are reimbursable under the loss-share agreements.

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**12. Financial Instruments with Off-Balance Sheet Risk**

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit that involve varying degrees of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Such financial instruments are recorded in the consolidated financial statements when they are funded or related fees are incurred or received. The contract amounts of those instruments reflect the extent of involvement (and therefore the exposure to credit loss) the Bank has in particular classes of financial instruments.

Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and may require payment of fees. Because some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

In the aggregate, the Bank had outstanding unused commitments to extend credit of \$1.4 billion at September 30, 2014 and outstanding financial and performance standby letters of credit of \$45.1 million at September 30, 2014.

The Bank uses the same credit policies in making commitments and standby letters of credit as it does for on-balance sheet instruments. The amount of collateral obtained, if deemed necessary, in these transactions is based on management's credit evaluation of the borrower. Collateral held varies but may include real estate, accounts receivable, marketable securities, interest-bearing deposit accounts, inventory, and property, plant and equipment.

In the normal course of business, FSC executes, settles, and finances various securities transactions that may expose FSC to off-balance sheet risk in the event that a customer or counterparty does not fulfill its contractual obligations. Examples of such transactions include the sale of securities not yet purchased by customers or for the account of FSC, clearing agreements between FSC and various clearinghouses and broker-dealers, secured financing arrangements that involve pledged securities, and when-issued underwriting and purchase commitments.

**13. Stock-Based Compensation**

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Pursuant to the Hilltop Holdings 2012 Equity Incentive Plan (the 2012 Plan ), the Company may grant nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, dividend equivalent rights and other awards to employees of the Company, its subsidiaries and outside directors of the Company. Upon the approval by stockholders and effectiveness of the 2012 Plan in September 2012, no additional awards were permissible under the 2003 Equity Incentive Plan (the 2003 Plan ). In the aggregate, 4,000,000 shares of common stock may be delivered pursuant to awards granted under the 2012 Plan. At September 30, 2014, 3,151,649 shares of common stock remain available for issuance pursuant to the 2012 Plan.

During the nine months ended September 30, 2014, the Compensation Committee of the Board of Directors of the Company awarded certain executives and key employees an aggregate of 370,536 restricted stock units ( RSUs ) pursuant to the 2012 Plan, of which 363,881 remain outstanding at September 30, 2014. At September 30, 2014, 293,844 of the outstanding RSUs are subject to time-based vesting conditions and generally cliff vest on the third anniversary of the grant date, and 70,037 outstanding RSUs vest based upon the achievement of certain performance goals over a three-year period. These RSUs are subject to service conditions set forth in the award agreements, with associated costs recognized on a straight-line basis over the respective vesting periods. The weighted average grant date fair value related to these RSUs was \$23.78 per share. At September 30, 2014, unrecognized compensation expense related to these RSUs was \$7.3 million, which will be amortized through June 2017. The RSUs are not transferable, and the shares of common stock issuable upon conversion of vested RSUs are generally subject to transfer restrictions for a period of one year following conversion, subject to certain exceptions. In addition, the applicable RSU award agreements provide for accelerated vesting under certain conditions.

During 2013, the Compensation Committee of the Board of Directors of the Company awarded certain executives and key

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

employees a total of 471,000 restricted shares of common stock ( Restricted Stock Awards ) pursuant to the 2012 Plan, of which 466,000 remain outstanding at September 30, 2014. These Restricted Stock Awards generally cliff vest on the third anniversary of the grant date and are subject to service conditions set forth in the award agreements, with associated costs recognized on a straight-line basis over the respective vesting periods. The weighted average grant date fair value related to these Restricted Stock Awards was \$13.32 per share. At September 30, 2014, unrecognized compensation expense related to these Restricted Stock Awards was \$3.2 million, which will be amortized through September 2016. The award agreements governing these Restricted Stock Awards provide for accelerated vesting under certain conditions.

During the nine months ended September 30, 2014 and 2013, Hilltop granted 7,227 and 6,504 shares of common stock to independent members of the Company's Board of Directors for services rendered to the Company pursuant to the 2012 Plan.

Stock options granted on November 2, 2011 to two senior executives pursuant to the 2003 Plan to purchase an aggregate of 600,000 shares of the Company's common stock (the Stock Option Awards ) at an exercise price of \$7.70 per share were outstanding at September 30, 2014. These Stock Option Awards vest in five equal installments beginning on the grant date, with the remainder vesting on each grant date anniversary through 2015. At September 30, 2014, unrecognized compensation expense related to these Stock Option Awards was \$0.1 million, which will be amortized through October 2015. These Stock Option Awards expire on November 2, 2016.

Compensation expense related to the plans was \$1.3 million and \$0.6 million for the three months ended September 30, 2014 and 2013, respectively, and \$3.3 million and \$1.1 million for the nine months ended September 30, 2014 and 2013, respectively.

**14. Regulatory Matters**

*Bank*

The Bank and Hilltop are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct, material effect on the consolidated financial statements. The regulations require us to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require the companies to maintain minimum amounts and ratios (set forth in the following table) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

In July 2013, federal banking regulators released final rules for the regulation of capital and liquidity for U.S. banking organizations, establishing a new comprehensive capital framework ( Basel III ) for U.S. banking organizations that will become effective for reporting periods beginning after January 1, 2015 (subject to a phase-in period through January 2019).

In addition, under the final rules, bank holding companies with less than \$15 billion in assets as of December 31, 2009 are allowed to continue to include junior subordinated debentures in Tier 1 capital, subject to certain restrictions. However, if an institution grows to above \$15 billion in assets as a result of an acquisition, or organically grows to above \$15 billion in assets and then makes an acquisition, the combined trust preferred issuances must be phased out of Tier 1 and into Tier 2 capital (75% in 2015 and 100% in 2016). It is possible that the Company may accelerate redemption of the existing junior subordinated debentures. All of the debentures issued to the Trusts, less the common stock of the Trusts, qualified as Tier 1 capital as of September 30, 2014, under guidance issued by the Board of Governors of the Federal Reserve System.

Management believes that, as of September 30, 2014, Hilltop and the Bank would meet all applicable capital adequacy

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requirements under the Basel III capital rules for banks with less than \$15 billion in assets on a fully phased-in basis as if such requirements were currently in effect.

The following table shows the Bank's and Hilltop's consolidated actual capital amounts and ratios compared to the regulatory minimum capital requirements and the Bank's regulatory minimum capital requirements needed to qualify as a well-capitalized institution (dollars in thousands), without giving effect to the final Basel III capital rules.

	Actual		Minimum Capital Requirements		To Be Well Capitalized Minimum Capital Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>September 30, 2014</b>						
Tier 1 capital (to average assets):						
Bank	\$ 822,306	9.95%	\$ 330,701	4%	\$ 413,376	5%
Hilltop	1,196,318	13.63%	351,148	4%	N/A	N/A
Tier 1 capital (to risk-weighted assets):						
Bank	822,306	13.48%	243,965	4%	\$ 365,947	6%
Hilltop	1,196,318	18.57%	257,653	4%	N/A	N/A
Total capital (to risk-weighted assets):						
Bank	866,457	14.21%	487,929	8%	\$ 609,911	10%
Hilltop	1,242,010	19.28%	515,307	8%	N/A	N/A
<b>December 31, 2013</b>						
Tier 1 capital (to average assets):						
Bank	\$ 762,364	9.29%	\$ 328,275	4%	\$ 410,344	5%
Hilltop	1,112,424	12.81%	347,480	4%	N/A	N/A
Tier 1 capital (to risk-weighted assets):						
Bank	762,364	13.38%	227,984	4%	341,976	6%
Hilltop	1,112,424	18.53%	240,159	4%	N/A	N/A
Total capital (to risk-weighted assets):						
Bank	797,771	14.00%	455,968	8%	569,960	10%
Hilltop	1,148,736	19.13%	480,318	8%	N/A	N/A

To be considered adequately capitalized (as defined) under regulatory requirements, the Bank must maintain minimum Tier 1 capital to total average assets and Tier 1 capital to risk-weighted assets ratios of 4%, and a total capital to risk-weighted assets ratio of 8%. Based on the actual capital amounts and ratios shown in the previous table, the Bank's ratios place it in the well-capitalized (as defined) capital category under regulatory requirements.

*Financial Advisory*

Pursuant to the net capital requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), FSC has elected to determine its net capital requirements using the alternative method. Accordingly, FSC is required to maintain minimum net capital, as defined in Rule 15c3-1 promulgated under the Exchange Act, equal to the greater of \$250,000 or 2% of aggregate debit balances, as defined in Rule 15c3-3 promulgated under the Exchange Act. At September 30, 2014, FSC had net capital of \$78.2 million (the minimum net capital requirement was \$5.6 million), net capital maintained by FSC was 28% of aggregate debits, and net capital in excess of the minimum requirement was \$72.6 million.

Under certain conditions, FSC may be required to segregate cash and securities in a special reserve account for the benefit of customers under Rule 15c3-3 promulgated under the Exchange Act. Assets segregated under the provisions of the Exchange Act are not available for general corporate purposes. FSC was required to segregate \$29.5 million in cash and securities at September 30, 2014, which is included in other assets within the consolidated balance sheet. At December 31, 2013, FSC was not required to segregate cash and securities.

FSC was not required to segregate cash or securities in a special reserve account for the benefit of proprietary accounts of

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

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introducing broker-dealers at September 30, 2014 and December 31, 2013.

*Mortgage Origination*

As a mortgage originator, PrimeLending is subject to minimum net worth requirements established by the United States Department of Housing and Urban Development ( HUD ) and the GNMA. On an annual basis, PrimeLending submits audited financial statements to HUD and GNMA documenting PrimeLending s compliance with its minimum net worth requirements. In addition, PrimeLending monitors compliance on an ongoing basis and, as of September 30, 2014, PrimeLending s net worth exceeded the amounts required by both HUD and GNMA.

*Insurance*

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

A summary of statutory capital and surplus and statutory net income (loss) of each insurance subsidiary is as follows (in thousands).

	September 30,		December 31,					
	2014		2013					
<b>Capital and surplus:</b>								
National Lloyds Insurance Company	\$	106,531	\$	98,602				
American Summit Insurance Company		27,604		26,452				
<b>Statutory net income (loss):</b>								
	Three Months Ended September 30,		Nine Months Ended September 30,					
	2014		2013					
National Lloyds Insurance Company	\$	6,106	\$	2,645	\$	7,428	\$	(7,296)
American Summit Insurance Company		(418)		167		958		(962)

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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, 2014, the Company's insurance subsidiaries had statutory surplus in excess of the minimum required.

The NAIC has adopted a risk based capital ( RBC ) formula for insurance companies that establishes minimum capital requirements indicating various levels of available regulatory action on an annual basis relating to insurance risk, asset credit risk, interest rate risk and business risk. The RBC 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 December 31, 2013, the most recent date for which the RBC calculation was performed, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required. As of September 30, 2014, management was not aware of any changes in financial condition or structure that would cause the Company's insurance subsidiaries to not be in compliance with the required RBC ratio.

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**15. Derivative Financial Instruments**

The Company uses various derivative financial instruments to mitigate interest rate risk. The Bank's interest rate risk management strategy involves effectively modifying the re-pricing characteristics of certain assets and liabilities so that changes in interest rates do not adversely affect the net interest margin. PrimeLending has interest rate risk relative to interest rate lock commitments ( IRLCs ) and its inventory of mortgage loans held for sale. PrimeLending is exposed to such rate risk from the time an IRLC is made to an applicant to the time the related mortgage loan is sold. To mitigate interest rate risk, PrimeLending executes forward commitments to sell mortgage-backed securities ( MBSs ). Additionally, PrimeLending has interest rate risk relative to its MSR asset. During the three months ended September 30, 2014, PrimeLending began using derivative instruments, including interest rate swaps and swaptions, to hedge this risk. FSC uses forward commitments to both purchase and sell MBSs to facilitate customer transactions and as a means to hedge related exposure to interest rate risk in certain inventory positions.

*Non-Hedging Derivative Instruments and the Fair Value Option*

As discussed in Note 3 to the consolidated financial statements, the Company has elected to measure substantially all mortgage loans held for sale at fair value under the provisions of the Fair Value Option. The election provides the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without applying complex hedge accounting provisions. The fair values of PrimeLending's IRLCs, forward commitments, and interest rate swaps and swaptions are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of these derivative instruments are recorded as a component of net gains from sale of loans and other mortgage production income. The fair value of PrimeLending's derivative instruments increased \$0.2 million for the three months ended September 30, 2014 and decreased \$48.9 million during the same period in 2013. The fair value of PrimeLending's derivative instruments decreased \$5.0 million and \$14.9 million for the nine months ended September 30, 2014 and 2013, respectively. Changes in fair value are attributable to changes in the volume of IRLCs, mortgage loans held for sale, commitments to purchase and sell MBSs and MSRs, and changes in market interest rates. Changes in market interest rates also conversely affect the value of PrimeLending's mortgage loans held for sale and its MSR asset, which are measured at fair value under the Fair Value Option. The effect of the change in market interest rates on PrimeLending's loans held for sale and MSR asset is discussed in Note 3 to the consolidated financial statements. The fair values of FSC's derivative instruments are recorded in other assets or other liabilities, as appropriate, and the fair values of FSC's derivatives increased \$5.3 million and \$3.2 million for the three months ended September 30, 2014 and 2013, respectively, and increased \$11.4 million and \$8.8 million for the nine months ended September 30, 2014 and 2013, respectively. The changes in fair value were recorded as a component of other noninterest income.

Derivative positions are presented in the following table (in thousands).

September 30, 2014		December 31, 2013	
Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value

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Derivative instruments:					
IRLCs	\$	842,127	\$	20,810	\$ 602,467 \$ 12,151
Commitments to purchase MBSs		489,361		4,040	236,305 (109)
Commitments to sell MBSs		2,201,379		(3,709)	1,645,332 11,383
Fee Award Option		20,420		(6,827)	20,432 (5,600)
Interest rate swaps and swaptions		79,000		409	

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**16. Balance Sheet Offsetting**

Certain financial instruments, including resale and repurchase agreements, securities lending arrangements and derivatives, may be eligible for offset in the consolidated balance sheets and/or subject to master netting arrangements or similar agreements. The following tables present the assets and liabilities subject to enforceable master netting arrangements, repurchase agreements, or similar agreements with offsetting rights (in thousands).

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet Financial Instruments	Cash Collateral Pledged	Net Amount
<b>September 30, 2014</b>						
Securities borrowed:						
Institutional counterparties	\$ 210,590	\$	\$ 210,590	\$ (210,590)	\$	\$
Interest rate swaps and swaptions:						
Institutional counterparties	409		409			409
Forward MBS derivatives:						
Institutional counterparties	9		9			9
	\$ 211,008	\$	\$ 211,008	\$ (210,590)	\$	\$ 418
<b>December 31, 2013</b>						
Securities borrowed:						
Institutional counterparties	\$ 107,365	\$	\$ 107,365	\$ (107,365)	\$	\$
Forward MBS derivatives:						
Institutional counterparties	11,489	(76)	11,413		(286)	11,127
	\$ 118,854	\$ (76)	\$ 118,778	\$ (107,365)	\$ (286)	\$ 11,127
	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Balance Sheet	Net Amounts of Liabilities Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet Financial Instruments	Cash Collateral Pledged	Net Amount
<b>September 30, 2014</b>						
Securities loaned:						
Institutional counterparties	\$ 157,212	\$	\$ 157,212	\$ (157,212)	\$	\$
Repurchase agreements:						
Customer counterparties	134,134		134,134	(134,134)		

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Forward MBS derivatives:

Institutional counterparties	4,163	(446)	3,717	(1,749)	1,968
	\$ 295,509	\$ (446)	\$ 295,063	\$ (291,346)	\$ (1,749) \$ 1,968

**December 31, 2013**

Securities loaned:

Institutional counterparties	\$ 74,913	\$	\$ 74,913	\$ (74,913)	\$
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Repurchase agreements:

Customer counterparties	107,462	107,462	(107,462)
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Forward MBS derivatives:

Institutional counterparties	30	30	(17)	13
	\$ 182,405	\$ 182,405	\$ (182,375)	\$ (17) \$ 13

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**17. Broker-Dealer and Clearing Organization Receivables and Payables**

Broker-dealer and clearing organization receivables and payables consisted of the following (in thousands).

	September 30, 2014		December 31, 2013
<b>Receivables:</b>			
Securities borrowed	\$ 210,590	\$	107,365
Securities failed to deliver	12,053		7,160
Clearing organizations	1,019		4,698
Due from dealers	17		94
	\$ 223,679	\$	119,317
<b>Payables:</b>			
Securities loaned	\$ 157,212	\$	74,913
Correspondents	51,797		44,852
Securities failed to receive	8,937		5,523
Clearing organizations	25,889		4,390
	\$ 243,835	\$	129,678

**18. Reserves for Unpaid Losses and Loss Adjustment Expenses**

Information regarding the reserve for unpaid losses and losses and loss adjustment expenses ( LAE ) are as follows (in thousands).

	Nine Months Ended September 30,	
	2014	2013
Balance, beginning of period	\$ 27,468	\$ 34,012
Less reinsurance recoverables	(4,508)	(10,385)
Net balance, beginning of period	22,960	23,627
<b>Incurred related to:</b>		
Current period	70,349	93,124
Prior periods	5,892	852
Total incurred	76,241	93,976
<b>Payments related to:</b>		
Current period	(55,701)	(78,742)

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Prior periods	(14,338)	(13,623)
Total payments	(70,039)	(92,365)
Net balance, end of period	29,162	25,238
Plus reinsurance recoverables	3,298	6,029
Balance, end of period	\$ 32,460	\$ 31,267

The increase in the reserves at September 30, 2014 as compared with September 30, 2013 of \$1.2 million is primarily due to increased reserves attributable to the prior period adverse development. This prior period adverse development totaled \$5.9 million during the nine months ended September 30, 2014 and was primarily related to litigation emerging from a series of hail storms within the 2012 accident year.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**19. Reinsurance Activity**

NLC limits 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, and these reinsurance contracts do not relieve NLC 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 insurance 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 insurance premiums ceded to them are reported as assets. Failure of reinsurers to honor their obligations could result in losses to NLC; consequently, allowances are established for amounts deemed uncollectible as NLC 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, 2014, reinsurance receivables have a carrying value of \$3.5 million, which is included in other assets within the consolidated balance sheet. There was no allowance for uncollectible accounts at September 30, 2014, based on NLC's quality requirements.

The effects of reinsurance on premiums written and earned are summarized as follows (in thousands).

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014		2013		2014		2013	
	Written	Earned	Written	Earned	Written	Earned	Written	Earned
Premiums from direct business	\$ 42,586	\$ 43,890	\$ 44,484	\$ 43,031	\$ 134,355	\$ 130,183	\$ 134,292	\$ 125,520
Reinsurance assumed	2,531	2,338	2,058	1,860	7,441	6,536	5,931	5,238
Reinsurance ceded	(4,604)	(4,407)	(5,100)	(4,909)	(14,085)	(13,802)	(14,879)	(14,713)
Net premiums	\$ 40,513	\$ 41,821	\$ 41,442	\$ 39,982	\$ 127,711	\$ 122,917	\$ 125,344	\$ 116,045

The effects of reinsurance on incurred losses are as follows (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Loss and LAE incurred	\$ 22,834	\$ 27,558	\$ 77,041	\$ 98,507
Reinsurance recoverables	(205)	(2,927)	(800)	(4,531)
Net loss and LAE incurred	\$ 22,629	\$ 24,631	\$ 76,241	\$ 93,976

*Multi-line excess of loss coverage*

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In addition to the catastrophe reinsurance noted below, both NLIC and ASIC participate in an excess of loss program placed with various reinsurers. This program is limited to each risk with respect to property and liability in the amount of \$500,000 for each of NLIC and ASIC. Each of NLIC and ASIC retain \$500,000 in this program.

### *Catastrophic coverage*

At September 30, 2014, NLC had catastrophic excess of loss reinsurance coverage of losses per event in excess of \$8 million retention by NLIC and \$1.5 million retention by ASIC. ASIC maintained an underlying layer of coverage, providing \$6.5 million in excess of its \$1.5 million retention to bridge to the primary program. The reinsurance in excess of \$8 million is comprised of four layers of protection: \$17 million in excess of \$8 million retention; \$25 million in excess of \$25 million loss; \$50 million in excess of \$50 million loss and \$40 million in excess of \$100 million loss. NLIC and ASIC retain no participation in any of the layers, beyond the first \$8 million and \$1.5 million, respectively. At September 30, 2014, total retention for any one catastrophe that affects both NLIC and ASIC was limited to \$8 million in the aggregate.

Additionally, NLC purchased an underlying excess of loss contract that provides \$10 million aggregate coverage for sub-catastrophic events. NLC retains a 34% participation in this coverage.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**20. Segment and Related Information**

The Company currently has four reportable business segments that are organized primarily by the core products offered to the segments respective customers. These segments reflect the manner in which operations are managed and the criteria used by the Company's chief operating decision maker function to evaluate segment performance, develop strategy and allocate resources. The chief operating decision maker function consists of the President and Chief Executive Officer of the Company and the Chief Executive Officer of PlainsCapital. During the fourth quarter of 2013, we began presenting certain amounts previously allocated to the four reportable business segments under the heading Corporate to better reflect our internal organizational structure. This change had no impact on the Company's consolidated results of operations. The Company's historical segment disclosures have been revised to conform to the current presentation.

The banking segment includes the operations of the Bank, which, since September 14, 2013, includes the operations acquired in the FNB Transaction. The mortgage origination segment is composed of PrimeLending. The insurance segment is composed of NLC. The financial advisory segment is composed of First Southwest.

Corporate includes certain activities not allocated to specific business segments. These activities include holding company financing and investing activities, and management and administrative services to support the overall operations of the Company including, but not limited to, certain executive management, corporate relations, legal, finance, and acquisition costs not allocated to business segments.

Balance sheet amounts for remaining subsidiaries not discussed previously and the elimination of intercompany transactions are included in All Other and Eliminations. The following tables present certain information about reportable segment revenues, operating results, goodwill and assets (in thousands).

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b><u>Three Months Ended</u></b>							
<b><u>September 30, 2014</u></b>							
Net interest income (expense)	\$ 78,285	\$ (3,197)	\$ 808	\$ 3,269	\$ 1,712	\$ 4,883	\$ 85,760
Provision for loan losses	4,049			(16)			4,033
Noninterest income	17,638	128,989	44,014	29,726		(8,232)	212,135
Noninterest expense	67,236	114,690	36,636	31,782	5,015	(615)	254,744
Income (loss) before income taxes	\$ 24,638	\$ 11,102	\$ 8,186	\$ 1,229	\$ (3,303)	\$ (2,734)	\$ 39,118
	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b><u>Nine Months Ended</u></b>							
<b><u>September 30, 2014</u></b>							

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Net interest income (expense)	\$ 248,686	\$ (9,726)	\$ 2,625	\$ 9,077	\$ 5,100	\$ 13,865	\$ 269,627
Provision for loan losses	12,793			15			12,808
Noninterest income	50,258	343,572	129,910	80,161		(18,385)	585,516
Noninterest expense	188,153	316,546	118,398	87,507	9,767	(1,786)	718,585
Income (loss) before income taxes	\$ 97,998	\$ 17,300	\$ 14,137	\$ 1,716	\$ (4,667)	\$ (2,734)	\$ 123,750

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b>Three Months Ended</b>							
<b>September 30, 2013</b>							
Net interest income (expense)	\$ 70,594	\$ (8,880)	\$ 911	\$ 2,690	\$ (68)	\$ 6,669	\$ 71,916
Provision for loan losses	10,661			(3)			10,658
Noninterest income	26,614	127,460	42,163	25,710		(6,852)	215,095
Noninterest expense	34,136	114,815	38,689	28,227	908	(183)	216,592
Income (loss) before income taxes	\$ 52,411	\$ 3,765	\$ 4,385	\$ 176	\$ (976)		\$ 59,761

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b>Nine Months Ended</b>							
<b>September 30, 2013</b>							
Net interest income (expense)	\$ 206,863	\$ (32,731)	\$ 2,796	\$ 9,445	\$ (304)	\$ 21,533	\$ 207,602
Provision for loan losses	34,927			25			34,952
Noninterest income	50,747	439,246	122,365	77,350		(22,102)	667,606
Noninterest expense	96,732	371,577	135,098	84,327	4,818	(569)	691,983
Income (loss) before income taxes	\$ 125,951	\$ 34,938	\$ (9,937)	\$ 2,443	\$ (5,122)		\$ 148,273

<b>September 30, 2014</b>							
Goodwill	\$ 207,741	\$ 13,071	\$ 23,988	\$ 7,008	\$	\$	\$ 251,808
Total assets	\$ 8,000,666	\$ 1,452,449	\$ 328,168	\$ 744,769	\$ 1,449,438	\$ (2,795,088)	\$ 9,180,402

<b>December 31, 2013</b>							
Goodwill	\$ 207,741	\$ 13,071	\$ 23,988	\$ 7,008	\$	\$	\$ 251,808
Total assets	\$ 7,981,517	\$ 1,249,091	\$ 308,160	\$ 520,412	\$ 1,316,398	\$ (2,471,456)	\$ 8,904,122

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

**21. Earnings per Common Share**

Nonvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of earnings per share pursuant to the two-class method prescribed by the Earnings Per Share Topic of the ASC. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. In May 2013, as discussed in Note 13 to the consolidated financial statements, Hilltop issued Restricted Stock Awards which qualify as participating securities.

Net earnings, less any preferred dividends accumulated for the period (whether or not declared), is allocated between the common stock and participating securities pursuant to the two-class method. Basic earnings per common share is computed by dividing net earnings available to common stockholders by the weighted average number of common shares outstanding during the period, excluding participating nonvested restricted shares.

Diluted earnings per common share is computed in a similar manner, except that first the denominator is increased to include the number of additional common shares that would have been outstanding if potentially dilutive common shares, excluding the participating securities, were issued using the treasury stock method. For the three and nine months ended September 30, 2014, stock options and RSUs are the only potentially dilutive non-participating instruments issued by Hilltop, while potentially dilutive non-participating instruments for the three and nine months ended September 30, 2013 included stock options, RSUs and the 7.50% Senior Exchangeable Notes due 2025 (the Notes), which were called for redemption during the fourth quarter of 2013. Next, we determine and include in the diluted earnings per common share calculation the more dilutive effect of the participating securities using the treasury stock method or the two-class method. Undistributed losses are not allocated to the nonvested share-based payment awards (the participating securities) under the two-class method as the holders are not contractually obligated to share in the losses of the Company.

The following table presents the computation of basic and diluted earnings per common share (in thousands, except per share data).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Basic earnings per share:				
Income applicable to Hilltop common stockholders	\$ 23,386	\$ 38,174	\$ 74,231	\$ 91,487
Less: income applicable to participating shares	(121)	(211)	(384)	(507)
Net earnings available to Hilltop common stockholders	\$ 23,265	\$ 37,963	\$ 73,847	\$ 90,980
Weighted average shares outstanding - basic	89,711	83,493	89,709	83,490
Basic earnings per common share	\$ 0.26	\$ 0.45	\$ 0.82	\$ 1.09

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Diluted earnings per share:

Income applicable to Hilltop common stockholders	\$	23,386	\$	38,174	\$	74,231	\$	91,487
Add: interest expense on senior exchangeable notes (net of tax)				1,053				3,158
Net earnings available to Hilltop common stockholders	\$	23,386	\$	39,227	\$	74,231	\$	94,645
Weighted average shares outstanding - basic		89,711		83,493		89,709		83,490
Effect of potentially dilutive securities		847		6,967		861		6,761
Weighted average shares outstanding - diluted		90,558		90,460		90,570		90,251
Diluted earnings per common share	\$	0.26	\$	0.43	\$	0.82	\$	1.05

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**22. Recently Issued Accounting Standards**

In August 2014, the FASB issued Accounting Standards Update ( ASU ) No. 2014-14 to reduce diversity in practice by clarifying how to classify and measure certain government-guaranteed mortgage loans upon foreclosure. The amendment is effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014 and may be adopted using either a modified retrospective transition method or a prospective transition method. The Company expects to adopt the amendment as of January 1, 2015 using the prospective transition method and does not expect the amendment to have a significant effect on its future consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09 which clarifies the principles for recognizing revenue from contracts with customers. The amendment outlines a single comprehensive model for entities to depict the transfer of goods or services to customers in amounts that reflect the payment to which a company expects to be entitled in exchange for those goods or services. The amendment also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The amendment is effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2016 and may be adopted using either a full retrospective transition method or a modified retrospective transition method. Early adoption is not permitted. The Company is currently evaluating the provisions of the amendment and the impact on its future consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08 which raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. The amendment is intended to reduce the frequency of disposals reported as discontinued operations by focusing on strategic shifts that have or will have a major effect on an entity's operations and financial results and will permit companies to have continuing cash flows and significant continuing involvement with the disposed component. The amendment is effective for disposals (or classifications as held for sale) and acquired businesses or nonprofit activities that are classified as held for sale upon acquisition that occur within annual periods beginning on or after December 15, 2014, and interim periods within those years. As such, the Company will evaluate the provisions of the amendment as it relates to any potential disposals or acquisitions beginning on or after January 1, 2015.

In January 2014, the FASB issued ASU No. 2014-04 to clarify that an in substance repossession or foreclosure occurs upon either the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2014 and may be adopted using either a modified retrospective transition method or a prospective transition method. The Company expects to adopt the amendment as of January 1, 2015 using the prospective transition method and does not expect the amendment to have a significant effect on its future consolidated financial statements.

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In July 2013, the FASB issued ASU No. 2013-11 to require an entity to present an unrecognized tax benefit, or portion thereof, in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. However, to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position, or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendment became effective for the Company on January 1, 2014, and its adoption did not have any effect on the Company's consolidated financial statements as the amendment is to be applied prospectively to all unrecognized tax benefits that exist at the balance sheet date.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**23. Subsequent Events**

On October 2, 2014, Hilltop exercised its SWS Warrant in full, acquiring 8,695,652 shares of SWS common stock at an exercise price of \$5.75 per share. Pursuant to the terms of the SWS Warrant and a credit agreement with SWS, the exercise price was paid by the automatic elimination of the \$50.0 million aggregate principal amount note due to Hilltop under the credit agreement. Following the exercise of the SWS Warrant, Hilltop (i) owns 10,171,039 shares of SWS common stock, representing approximately 21% of the outstanding shares of SWS common stock as of October 4, 2014, and (ii) is no longer a lender under the credit agreement.

On October 24, 2014, the Bank notified its federal and state banking regulators and affected customers that, effective January 30, 2015, it will be closing certain branch locations acquired in the FNB Transaction. Eleven of the branches to be closed are located in the Texas Rio Grande Valley, and the remaining two branches are located in Houston and Laredo, Texas. The Bank previously notified its federal and state banking regulators and affected customers that it will be closing two other branches acquired in the FNB Transaction in the Houston market effective November 7, 2014.



- our ability to estimate loan losses;
- changes in the default rate of our loans;
- risks associated with concentration in real estate related loans;
- our ability to obtain reimbursements for losses on acquired loans under loss-share agreements with the Federal Deposit Insurance Corporation (the "FDIC");
- changes in general economic, market and business conditions in areas or markets where we compete;
- severe catastrophic events in our geographic area;
- changes in the interest rate environment;
- cost and availability of capital;

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- changes in state and federal laws, regulations or policies affecting one or more of our business segments, including changes in regulatory fees, deposit insurance premiums, capital requirements and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act );
- our ability to use net operating loss carry forwards to reduce future tax payments;
- approval of new, or changes in, accounting policies and practices;
- changes in key management;
- competition in our banking, mortgage origination, financial advisory and insurance segments from other banks and financial institutions as well as insurance companies, mortgage bankers, investment banking and financial advisory firms, asset-based non-bank lenders and government agencies;
- failure of our insurance segment reinsurers to pay obligations under reinsurance contracts;
- our ability to use excess cash in an effective manner, including the execution of successful acquisitions; and
- our participation in governmental programs, including the Small Business Lending Fund ( SBLF ).

For a more detailed discussion of these and other factors that may affect our business and that could cause the actual results to differ materially from those anticipated in these forward-looking statements, please refer to Risk Factors in Part I, Item 1A of our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission (the SEC ) on March 3, 2014, this Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, Part II, Item 1A, Risk Factors herein and other filings we have made with the SEC. We caution that the foregoing list of factors is not exhaustive, and new factors may emerge, or changes to the foregoing factors may occur, that could impact our business. All subsequent written and oral forward-looking statements concerning our business attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements above. We do not undertake any obligation to update any forward-looking statement, whether written or oral, relating to the matters discussed in this Quarterly Report except to the extent required by federal securities laws.

**OVERVIEW**

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We are a financial holding company registered under the Bank Holding Company Act of 1956, as amended by the Gramm-Leach-Bliley Act of 1999. Our primary line of business is to provide business and consumer banking services from offices located throughout Texas. We also provide an array of financial products and services such as mortgage origination, insurance and financial advisory services.

On September 13, 2013 (the Bank Closing Date), the Bank assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of Edinburg, Texas-based FNB from the FDIC, as receiver, and reopened former branches of FNB acquired from the FDIC under the PlainsCapital Bank name (the FNB Transaction). Pursuant to the Purchase and Assumption Agreement by and among the FDIC as receiver for FNB, the FDIC and the Bank (the P&A Agreement), the Bank and the FDIC entered into loss-share agreements whereby the FDIC agreed to share in the losses of certain covered loans and covered other real estate owned (OREO) that the Bank acquired in the FNB Transaction. The fair value of the assets acquired was \$2.2 billion, including \$1.1 billion in covered loans, \$286.2 million in securities, \$135.2 million in covered OREO and \$42.9 million in non-covered loans. The Bank also assumed \$2.2 billion in liabilities, consisting primarily of deposits.

On March 31, 2014, we entered into a definitive merger agreement with SWS providing for the merger of SWS with and into a subsidiary of Hilltop formed for the purpose of facilitating this transaction. Under the terms of the merger agreement, SWS stockholders will receive per share consideration of 0.2496 shares of Hilltop common stock and \$1.94 of cash, equating to \$6.94 per share based on Hilltop's closing price on September 30, 2014. The value of the merger consideration will fluctuate with the market price of Hilltop common stock. We intend to fund the cash portion of the consideration through available cash. The merger is subject to customary closing conditions, including regulatory approvals and approval of the stockholders of SWS, and is expected to be completed prior to the end of 2014.

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At September 30, 2014, on a consolidated basis, we had total assets of \$9.2 billion, total deposits of \$6.2 billion, total loans, including loans held for sale, of \$5.8 billion and stockholders' equity of \$1.4 billion. Our banking operations include the operations acquired in the FNB Transaction since September 14, 2013.

Management made significant estimates and exercised significant judgment in estimating fair values and accounting associated with the FNB Transaction during the third quarter of 2013 due to the short time period between the Bank Closing Date and September 30, 2013. The Bank Closing Date valuations related to loans, FDIC Indemnification Asset, covered OREO, other intangible assets, assumed liabilities and taxes were considered preliminary at September 30, 2013. The operations of FNB were included in our operating results beginning September 14, 2013 and such operations included a preliminary bargain purchase gain of \$3.3 million, before income taxes of \$1.2 million, as disclosed in our Quarterly Report on Form 10-Q filed with the SEC on November 12, 2013.

During the quarter ended December 31, 2013, the estimated fair values of certain identifiable assets acquired and liabilities assumed as of the Bank Closing Date were adjusted in accordance with the Business Combinations Topic of the Accounting Standards Codification (ASC) as a result of additional information obtained about the facts and circumstances that existed as of the Bank Closing Date primarily related to the fair values of loans, covered OREO, FDIC Indemnification Asset, premises and equipment and other intangible assets. These adjustments resulted in an increase in the preliminary bargain purchase gain associated with the FNB Transaction to \$12.6 million, before income taxes of \$4.5 million. This change is reflected in the revised consolidated statements of operations within noninterest income during the three and nine months ended September 30, 2013. In the aggregate, the adjustments to the preliminary bargain purchase gain and related revisions to the accretion of discount on loans and other items increased net income for the three and nine months ended September 30, 2013 by \$6.3 million as compared with amounts previously reported in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2013. Additionally, certain amounts previously reported in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 within the consolidated balance sheet as of September 30, 2013, the related statements of comprehensive income (loss), stockholders' equity and cash flows for the three and nine months ended September 30, 2013, as well as the notes to the consolidated financial statements, have been revised accordingly.

***Segment Information***

We have two primary operating business units, PlainsCapital (financial services and products) and NLC (insurance). Within the PlainsCapital unit are three primary wholly owned operating subsidiaries: the Bank, PrimeLending and First Southwest. Under accounting principles generally accepted in the United States (GAAP), our business units are comprised of four reportable business segments organized primarily by the core products offered to the segments' respective customers: banking, mortgage origination, insurance and financial advisory. During the fourth quarter of 2013, we began presenting certain amounts previously allocated to the four reportable business segments under the heading Corporate to better reflect our internal organizational structure. This change had no impact on our consolidated results of operations. Our historical segment disclosures and Management's Discussion and Analysis of Financial Condition and Results of Operations have been revised to conform to the current presentation. Consistent with the segment operating results during 2013, we anticipate that future earnings will be driven primarily from the banking segment, with the remainder being generated by our mortgage origination, insurance and financial advisory segments. Based on historical results of PlainsCapital Corporation, which we acquired on November 30, 2012, the relative share of total revenue provided by our banking and mortgage origination segments fluctuates depending on market conditions, and operating results for the mortgage origination segment tend to be more volatile than operating results for the banking segment.

The banking segment includes the operations of the Bank and, since September 14, 2013, the operations acquired in the FNB Transaction. The banking segment primarily provides business and consumer banking products and services from offices located throughout Texas and generates revenue from its portfolio of earning assets. The Bank's results of operations are primarily dependent on net interest income, while also deriving revenue from other sources, including service charges on customer deposit accounts and trust fees.

The mortgage origination segment includes the operations of PrimeLending, which offers a variety of loan products from offices in 42 states and generates revenue predominantly from fees charged on the origination of loans and from selling these loans in the secondary market.

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The insurance segment includes the operations of NLC, which operates through its wholly owned subsidiaries, National Lloyds Insurance Company ( NLIC ) and American Summit Insurance Company ( ASIC ). Insurance segment income is primarily generated from revenue earned on net insurance premiums less loss and loss adjustment expenses ( LAE ) and policy acquisition and other underwriting expenses in Texas and other areas of the southern United States.

The financial advisory segment generates a majority of its revenues from fees and commissions earned from investment advisory and securities brokerage services at First Southwest. The principal subsidiaries of First Southwest are FSC, a broker-dealer registered with the SEC and Financial Industry Regulatory Authority and a member of the New York Stock Exchange, and First Southwest Asset Management, Inc., a registered investment advisor under the Investment Advisors Act of 1940. FSC holds trading securities to support sales, underwriting and other customer activities. These securities are marked to market through other noninterest income. FSC uses derivatives to support mortgage origination programs of certain non-profit housing organization clients. FSC hedges its related exposure to interest rate risk from these programs with U.S. Agency to-be-announced, or TBA, mortgage-backed securities. These derivatives are marked to market through other noninterest income.

Corporate includes certain activities not allocated to specific business segments. These activities include holding company financing and investing activities, and management and administrative services to support the overall operations of the Company including, but not limited to, certain executive management, corporate relations, legal, finance, and acquisition costs not allocated to business segments. Balance sheet amounts for remaining subsidiaries not discussed previously and the elimination of intercompany transactions are included in All Other and Eliminations.

Additional information concerning our reportable segments is presented in Note 20, Segment and Related Information, in the notes to our consolidated financial statements. The following tables present certain information about the operating results of our reportable segments (in thousands).

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b>Three Months Ended September 30, 2014</b>							
Net interest income (expense)	\$ 78,285	\$ (3,197)	\$ 808	\$ 3,269	\$ 1,712	\$ 4,883	\$ 85,760
Provision for loan losses	4,049			(16)			4,033
Noninterest income	17,638	128,989	44,014	29,726		(8,232)	212,135
Noninterest expense	67,236	114,690	36,636	31,782	5,015	(615)	254,744
Income (loss) before income taxes	\$ 24,638	\$ 11,102	\$ 8,186	\$ 1,229	\$ (3,303)	\$ (2,734)	\$ 39,118

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b>Nine Months Ended September 30, 2014</b>							
Net interest income (expense)	\$ 248,686	\$ (9,726)	\$ 2,625	\$ 9,077	\$ 5,100	\$ 13,865	\$ 269,627
Provision for loan losses	12,793			15			12,808
Noninterest income	50,258	343,572	129,910	80,161		(18,385)	585,516
Noninterest expense	188,153	316,546	118,398	87,507	9,767	(1,786)	718,585
Income (loss) before income taxes	\$ 97,998	\$ 17,300	\$ 14,137	\$ 1,716	\$ (4,667)	\$ (2,734)	\$ 123,750

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b>Three Months Ended September 30, 2013</b>							
Net interest income (expense)	\$ 70,594	\$ (8,880)	\$ 911	\$ 2,690	\$ (68)	\$ 6,669	\$ 71,916

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Provision for loan losses	10,661			(3)				10,658
Noninterest income	26,614	127,460	42,163	25,710		(6,852)		215,095
Noninterest expense	34,136	114,815	38,689	28,227	908	(183)		216,592
Income (loss) before income taxes	\$ 52,411	\$ 3,765	\$ 4,385	\$ 176	\$ (976)	\$	\$	\$ 59,761

	Banking	Mortgage Origination	Insurance	Financial Advisory	Corporate	All Other and Eliminations	Hilltop Consolidated
<b>Nine Months Ended September 30, 2013</b>							
Net interest income (expense)	\$ 206,863	\$ (32,731)	\$ 2,796	\$ 9,445	\$ (304)	\$ 21,533	\$ 207,602
Provision for loan losses	34,927			25			34,952
Noninterest income	50,747	439,246	122,365	77,350		(22,102)	667,606
Noninterest expense	96,732	371,577	135,098	84,327	4,818	(569)	691,983
Income (loss) before income taxes	\$ 125,951	\$ 34,938	\$ (9,937)	\$ 2,443	\$ (5,122)	\$	\$ 148,273

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***How We Generate Revenue***

We generate revenue from net interest income and from noninterest income. Net interest income represents the difference between the income earned on our assets, including our loans and investment securities, and our cost of funds, including the interest paid on the deposits and borrowings that are used to support our assets. Net interest income is a significant contributor to our operating results. Fluctuations in interest rates, as well as the amounts and types of interest-earning assets and interest-bearing liabilities we hold, affect net interest income. We generated \$269.6 million in net interest income during the nine months ended September 30, 2014, compared with net interest income of \$207.6 million during the same period in 2013. The year-over-year increase in net interest income was primarily due to the inclusion of those operations acquired as a part of the FNB Transaction within our banking segment.

The other component of our revenue is noninterest income, which is primarily comprised of the following:

(i) *Income from mortgage operations.* Through our wholly owned subsidiary, PrimeLending, we generate noninterest income by originating and selling mortgage loans. During the nine months ended September 30, 2014 and 2013, we generated \$340.7 million and \$439.1 million, respectively, in net gains from the sale of loans, other mortgage production income (including income associated with retained mortgage servicing rights), and mortgage loan origination fees.

(ii) *Net insurance premiums earned.* Through our wholly owned insurance subsidiary, NLC, we provide fire and limited homeowners insurance for low value dwellings and manufactured homes. We generated \$122.9 million in net insurance premiums earned during the nine months ended September 30, 2014, compared with \$116.0 million during the same period in the prior year.

(iii) *Investment advisory fees and commissions and securities brokerage fees and commissions.* Through our wholly owned subsidiary, First Southwest, we provide public finance advisory and various investment banking and brokerage services. We generated \$67.7 million and \$70.3 million in investment advisory fees and commissions and securities brokerage fees and commissions during the nine months ended September 30, 2014 and 2013, respectively.

In the aggregate, we generated \$585.5 million and \$667.6 million in noninterest income during the nine months ended September 30, 2014 and 2013, respectively. The significant year-over-year decrease in noninterest income was primarily due to the decrease in loan origination volume within our mortgage origination segment and, to a lesser extent, the recognition of a pre-tax bargain purchase gain related to the FNB Transaction of \$12.6 million during the quarter ended September 30, 2013 within our banking segment, partially offset by increases in noninterest income in our banking, insurance and financial advisory segments.

We also incur noninterest expenses in the operation of our businesses. Our businesses engage in labor intensive activities and, consequently, employees' compensation and benefits represent the majority of our noninterest expenses.

***Consolidated Operating Results***

Net income applicable to common stockholders for the three months ended September 30, 2014 was \$23.4 million, or \$0.26 per diluted share, compared with net income applicable to common stockholders of \$38.2 million, or \$0.43 per diluted share, for the three months ended September 30, 2013. Net income applicable to common stockholders for the nine months ended September 30, 2014 was \$74.2 million, or \$0.82 per diluted share, compared with net income applicable to common stockholders of \$91.5 million, or \$1.05 per diluted share, for the nine months ended September 30, 2013. The consolidated operating results for the three and nine months ended September 30, 2013 include the recognition of a bargain purchase gain related to the FNB Transaction of \$12.6 million, before income taxes of \$4.5 million, during the quarter ended September 30, 2013.

Certain items included in net income for 2013 and 2014 resulted from purchase accounting associated with the merger of PlainsCapital Corporation with and into a wholly owned subsidiary of Hilltop on November 30, 2012 (the PlainsCapital Merger ) and the FNB Transaction. Income before income taxes for the three months ended September 30, 2014 includes net accretion of \$3.9 million and \$11.9 million on earning assets and liabilities acquired in the PlainsCapital Merger and FNB Transaction, respectively, offset by amortization of identifiable intangibles of \$2.3 million and \$0.3 million, respectively. During the three months ended September 30, 2013, income before income taxes includes net accretion of \$15.2 million on

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earning assets and liabilities acquired in the PlainsCapital Merger, offset by amortization of identifiable intangibles of \$2.5 million. Income before income taxes for the nine months ended September 30, 2014 includes net accretion of \$30.8 million and \$31.8 million on earning assets and liabilities acquired in the PlainsCapital Merger and FNB Transaction, respectively, offset by amortization of identifiable intangibles of \$7.0 million and \$0.8 million, respectively. During the nine months ended September 30, 2013, income before income taxes includes net accretion of \$47.1 million on earning assets and liabilities acquired in the PlainsCapital Merger, offset by amortization of identifiable intangibles of \$7.4 million.

We consider the ratios shown in the table below to be key indicators of our performance.

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Year Ended December 31, 2013
<b>Performance Ratios:</b>					
Return on average stockholders' equity	6.51%	12.73%	7.37%	10.57%	10.48%
Return on average assets	1.03%	2.08%	1.14%	1.75%	1.66%
Net interest margin (taxable equivalent) (1)	4.38%	4.46%	4.72%	4.39%	4.47%

(1) Taxable equivalent net interest income divided by average interest-earning assets.

During the three months ended September 30, 2014, the consolidated taxable equivalent net interest margin of 4.38% was impacted by PlainsCapital Merger-related accretion of discount on loans of \$4.6 million, amortization of premium on acquired securities of \$0.9 million and amortization of premium on acquired time deposits of \$0.2 million. Additionally, FNB Transaction related accretion of discount on loans of \$11.0 million and amortization of premium on acquired time deposits of \$0.9 million also impacted the consolidated taxable equivalent net interest margin during the three months ended September 30, 2014. These items increased the consolidated taxable equivalent net interest margin by 87 basis points for the three months ended September 30, 2014. The consolidated taxable equivalent net interest margin was 4.46% for the three months ended September 30, 2013. The taxable equivalent net interest margin for the third quarter of 2013 was impacted by PlainsCapital Merger-related accretion of discount on loans of \$16.1 million, amortization of premium on acquired securities of \$1.2 million and amortization of premium on acquired time deposits of \$0.8 million. These items increased the consolidated taxable equivalent interest margin by 96 basis points for the three months ended September 30, 2013.

During the nine months ended September 30, 2014, the consolidated taxable equivalent net interest margin of 4.72% was impacted by PlainsCapital Merger-related accretion of discount on loans of \$33.2 million, amortization of premium on acquired securities of \$2.8 million and amortization of premium on acquired time deposits of \$0.5 million. Additionally, FNB Transaction related accretion of discount on loans of \$26.3 million and amortization of premium on acquired time deposits of \$5.5 million also impacted the consolidated taxable equivalent net interest margin during the nine months ended September 30, 2014. These items increased the consolidated taxable equivalent net interest margin by 108 basis points for the nine months ended September 30, 2014. The consolidated taxable equivalent net interest margin was 4.39% for the nine months ended September 30, 2013. The taxable equivalent net interest margin for the nine months ended September 30, 2013 was impacted by PlainsCapital Merger-related accretion of discount on loans of \$49.8 million, amortization of premium on acquired securities of \$4.6 million and amortization of premium on acquired time deposits of \$2.4 million. These items increased the consolidated taxable equivalent interest margin by 95 basis points for the nine months ended September 30, 2013.

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The tables below provide additional details regarding our consolidated net interest income (dollars in thousands).

	Three Months Ended September 30,					
	Average Outstanding Balance	2014 Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	2013 Interest Earned or Paid	Annualized Yield or Rate
<b>Assets</b>						
Interest-earning assets						
Loans, gross (1)	\$ 5,641,750	\$ 80,719	5.65%	\$ 4,451,589	\$ 68,585	6.07%
Investment securities - taxable	1,161,583	7,688	2.63%	976,775	7,202	2.93%
Investment securities - non-taxable (2)	185,394	1,731	3.74%	166,789	1,594	3.82%
Federal funds sold and securities purchased under agreements to resell	14,459	10	0.29%	36,762	35	0.38%
Interest-bearing deposits in other financial institutions	566,195	303	0.21%	612,955	282	0.26%
Other	258,325	3,347	5.13%	166,559	2,546	6.07%
Interest-earning assets, gross	7,827,706	93,798	4.74%	6,411,429	80,244	4.94%
Allowance for loan losses	(40,934)			(29,042)		
Interest-earning assets, net	7,786,772			6,382,387		
Noninterest-earning assets	1,290,543			915,985		
<b>Total assets</b>	<b>\$ 9,077,315</b>			<b>\$ 7,298,372</b>		
<b>Liabilities and Stockholders Equity</b>						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 4,265,012	\$ 4,117	0.38%	\$ 3,683,586	\$ 3,685	0.40%
Notes payable and other borrowings	1,168,461	3,340	1.12%	802,391	4,101	2.02%
Total interest-bearing liabilities	5,433,473	7,457	0.54%	4,485,977	7,786	0.69%
Noninterest-bearing liabilities						
Noninterest-bearing deposits	1,891,576			1,354,460		
Other liabilities	338,825			276,210		
Total liabilities	7,663,874			6,116,647		
Stockholders' equity	1,412,913			1,181,165		
Noncontrolling interest	528			560		
<b>Total liabilities and stockholders' equity</b>	<b>\$ 9,077,315</b>			<b>\$ 7,298,372</b>		
<b>Net interest income (2)</b>		<b>\$ 86,341</b>			<b>\$ 72,458</b>	
<b>Net interest spread (2)</b>			<b>4.20%</b>			<b>4.25%</b>
<b>Net interest margin (2)</b>			<b>4.38%</b>			<b>4.46%</b>

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	Nine Months Ended September 30,					
	Average Outstanding Balance	2014 Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	2013 Interest Earned or Paid	Annualized Yield or Rate
<b>Assets</b>						
Interest-earning assets						
Loans, gross (1)	\$ 5,414,602	\$ 252,667	6.18%	\$ 4,338,209	\$ 198,684	6.06%
Investment securities - taxable	1,142,843	22,894	2.67%	958,220	19,594	2.72%
Investment securities - non-taxable (2)	184,697	5,374	4.53%	195,316	5,390	4.29%
Federal funds sold and securities purchased under agreements to resell	20,324	43	0.29%	27,281	91	0.45%
Interest-bearing deposits in other financial institutions	701,455	1,215	0.23%	646,800	857	0.25%
Other	221,928	9,055	5.44%	162,001	7,660	6.32%
Interest-earning assets, gross	7,685,849	291,248	5.04%	6,327,827	232,276	4.89%
Allowance for loan losses	(38,916)			(18,884)		
Interest-earning assets, net	7,646,933			6,308,943		
Noninterest-earning assets	1,320,764			869,254		
<b>Total assets</b>	<b>\$ 8,967,697</b>			<b>\$ 7,178,197</b>		
<b>Liabilities and Stockholders Equity</b>						
<b>Equity</b>						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 4,576,633	\$ 10,972	0.32%	\$ 3,540,786	\$ 10,541	0.40%
Notes payable and other borrowings	934,740	8,854	1.25%	899,022	12,331	1.82%
Total interest-bearing liabilities	5,511,373	19,826	0.48%	4,439,808	22,872	0.69%
Noninterest-bearing liabilities						
Noninterest-bearing deposits	1,792,014			1,242,101		
Other liabilities	289,550			321,098		
Total liabilities	7,592,937			6,003,007		
Stockholders equity	1,374,274			1,174,512		
Noncontrolling interest	486			678		
<b>Total liabilities and stockholders equity</b>	<b>\$ 8,967,697</b>			<b>\$ 7,178,197</b>		
<b>Net interest income (2)</b>		<b>\$ 271,422</b>			<b>\$ 209,985</b>	
<b>Net interest spread (2)</b>			<b>4.56%</b>			<b>4.22%</b>
<b>Net interest margin (2)</b>			<b>4.72%</b>			<b>4.39%</b>

(1) Average balance includes non-accrual loans.

(2) Annualized taxable equivalent adjustments are based on a 35% tax rate. The adjustment to interest income was \$0.6 million and \$0.5 million for the three months ended September 30, 2014 and 2013, respectively, and \$1.8 million for each of the nine months ended September 30, 2014 and 2013.

On a consolidated basis, net interest income increased \$13.8 million and \$62.0 million during the three and nine months ended September 30, 2014, compared with the same periods in 2013. These increases were primarily due to the inclusion of those operations acquired as a part of the FNB Transaction within our banking segment.

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable losses within the existing loan portfolio. The consolidated provision for loan losses, primarily in the banking segment, was \$4.0 million and \$10.7 million during the three months ended September 30, 2014 and 2013, respectively. During the three months ended September 30, 2014 and 2013, the provision for loan losses was comprised of charges relating to newly originated loans and acquired loans without credit impairment at acquisition of \$2.6 million and \$8.4 million, respectively, and purchased credit impaired (PCI) loans of \$1.4 million and \$2.3 million, respectively. During the nine months ended September 30, 2014 and 2013, the consolidated provision for loan losses, primarily in the banking segment, was \$12.8 million and \$35.0 million, respectively. The provision for loan losses during the nine months ended September 30, 2014 and 2013 was comprised of charges relating to newly originated loans and acquired loans without credit impairment at acquisition of \$7.9 million and \$32.0 million, respectively, and PCI loans of \$4.9 million and \$3.0 million, respectively.

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Consolidated noninterest income decreased \$3.0 million and \$82.1 million during the three and nine months ended September 30, 2014, respectively, compared with the same periods in 2013. These year-over-year changes included the recognition of a pre-tax bargain purchase gain related to the FNB Transaction of \$12.6 million during the quarter ended September 30, 2013. The remaining changes between the three months ended September 30, 2014 and 2013 were primarily due to increases in noninterest income in our banking and financial advisory segments of \$3.6 million and \$4.0 million, respectively, while the remaining changes in noninterest income between the nine months ended September 30, 2014 and 2013 included the reduction in net gains from sale of loans, other mortgage production income and mortgage loan origination fees within our mortgage origination segment of \$98.4 million, slightly offset by increases in noninterest income in our banking and insurance segments of \$12.1 million and \$7.5 million, respectively.

Our consolidated noninterest expense during the three and nine months ended September 30, 2014 increased \$38.2 million and \$26.6 million, respectively, compared with the same periods in 2013. The year-over-year increase between the three months ended September 30, 2014 and 2013 included significant increases in noninterest expenses within our banking segment of \$33.1 million, primarily due to the inclusion of those operations acquired as part of the FNB Transaction. The year-over-year changes between the nine months ended September 30, 2014 and 2013 included significant increases in noninterest expenses within our banking segment of \$91.4 million, primarily due to the inclusion of those operations acquired as part of the FNB Transaction, which were offset by significant decreases in noninterest expenses within our mortgage origination segment of \$55.0 million, primarily due to reductions in variable compensation tied to mortgage loan originations and initiatives to decrease segment operating costs, and within our insurance segment of \$16.7 million due to improved claims loss experience associated with the significant decline in the severity of severe weather-related events during 2014. Changes between the nine months ended September 30, 2014 and 2013 within the major components of noninterest expense included decreases of \$10.8 million in employees' compensation and benefits and \$17.7 million in loss and loss adjustment expenses, partially offset by increases of \$16.9 million in occupancy and equipment and \$37.5 million in other expenses.

Consolidated income tax expense during the three months ended September 30, 2014 and 2013 was \$14.0 million and \$20.1 million, respectively, reflecting effective rates of 35.8% and 33.7%, respectively. During the nine months ended September 30, 2014 and 2013, consolidated income tax expense was \$44.7 million and \$52.6 million, respectively, reflecting effective rates of 36.1% and 35.5%, respectively.

***Segment Results***

**Banking Segment**

Income before income taxes in our banking segment for the three months ended September 30, 2014 and 2013 was \$24.6 million and \$52.4 million, respectively. This year-over-year decrease of \$27.8 million included the recognition of a pre-tax bargain purchase gain related to the FNB Transaction of \$12.6 million during the quarter ended September 30, 2013. The remaining changes in income before income taxes between the three months ended September 30, 2014 and 2013 were primarily due to an increase in noninterest expenses, partially offset by increases in net interest income and noninterest income other than bargain purchase gain and a decrease in the provision for loan losses. Income before income taxes in our banking segment for the nine months ended September 30, 2014 and 2013 was \$98.0 million and \$126.0 million, respectively. In addition to the effects of the pre-tax bargain purchase gain discussed above, this year-over-year decrease in income before income taxes between the nine months ended September 30, 2014 and 2013 of \$28.0 million included increases in net interest income and noninterest income other than bargain purchase gain and a decrease in the provision for loan losses, significantly offset by an increase in noninterest expense. The operations acquired as a part of the FNB Transaction had a significant effect on each of the components of income before income taxes during both the three and nine months ended September 30, 2014, compared with the same periods in 2013.



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We consider the ratios shown in the table below to be key indicators of the performance of our banking segment.

	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013	Year Ended December 31, 2013
<b>Performance Ratios:</b>					
Efficiency ratio (1)	70.09%	35.12%	62.94%	37.55%	42.58%
Return on average assets	0.77%	2.23%	1.05%	1.86%	1.78%
Net interest margin (taxable equivalent) (2)	4.62%	5.09%	4.98%	5.16%	5.17%

(1) Noninterest expenses divided by the sum of total noninterest income and net interest income for the period.

(2) Taxable equivalent net interest income divided by average interest-earning assets.

During the three months ended September 30, 2014, the banking segment's taxable equivalent net interest margin of 4.62% was impacted by PlainsCapital Merger-related accretion of discount on loans of \$4.6 million, amortization of premium on acquired securities of \$0.9 million and amortization of premium on acquired time deposits of \$0.2 million. Additionally, FNB Transaction related accretion of discount on loans of \$11.0 million and amortization of premium on acquired time deposits of \$0.9 million also impacted the banking segment's taxable equivalent net interest margin during the three months ended September 30, 2014. These items increased the banking segment's taxable equivalent net interest margin by 102 basis points for the three months ended September 30, 2014. The banking segment's taxable equivalent net interest margin for the three months ended September 30, 2013 of 5.09% was impacted by PlainsCapital Merger-related accretion of discount on loans of \$16.1 million, amortization of premium on acquired securities of \$1.2 million and amortization of premium on acquired time deposits of \$0.8 million. These items increased the banking segment's taxable equivalent interest margin by 113 basis points for three months ended September 30, 2013.

During the nine months ended September 30, 2014, the banking segment's taxable equivalent net interest margin of 4.98% was impacted by PlainsCapital Merger-related accretion of discount on loans of \$33.2 million, amortization of premium on acquired securities of \$2.8 million and amortization of premium on acquired time deposits of \$0.4 million. Additionally, FNB Transaction related accretion of discount on loans of \$26.3 million and amortization of premium on acquired time deposits of \$5.5 million also impacted the banking segment's taxable equivalent net interest margin during the nine months ended September 30, 2014. These items increased the banking segment's taxable equivalent net interest margin by 124 basis points for the nine months ended September 30, 2014. The banking segment's taxable equivalent net interest margin for the nine months ended September 30, 2013 of 5.16% was impacted by PlainsCapital Merger-related accretion of discount on loans of \$49.8 million, amortization of premium on acquired securities of \$4.6 million and amortization of premium on acquired time deposits of \$2.4 million. These items increased the banking segment's taxable equivalent interest margin by 114 basis points for nine months ended September 30, 2013.

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The tables below provide additional details regarding our banking segment's net interest income (dollars in thousands).

	Three Months Ended September 30,					
	Average Outstanding Balance	2014 Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	2013 Interest Earned or Paid	Annualized Yield or Rate
<b>Assets</b>						
Interest-earning assets						
Loans, gross (1)	\$ 4,152,093	\$ 66,998	6.36%	\$ 3,135,680	\$ 56,383	7.06%
Subsidiary warehouse lines of credit	1,090,561	10,089	3.62%	970,323	12,907	5.20%
Investment securities - taxable	930,658	4,552	1.96%	789,451	4,088	2.07%
Investment securities - non-taxable (2)	149,586	1,453	3.89%	154,518	1,429	3.70%
Federal funds sold and securities purchased under agreements to resell	14,459	11	0.29%	35,127	25	0.29%
Interest-bearing deposits in other financial institutions	395,292	250	0.25%	392,570	282	0.29%
Other	58,742	486	3.31%	41,798	385	3.68%
Interest-earning assets, gross	6,791,391	83,839	4.87%	5,519,467	75,499	5.38%
Allowance for loan losses	(40,757)			(28,885)		
Interest-earning assets, net	6,750,634			5,490,582		
Noninterest-earning assets	1,236,336			893,160		
<b>Total assets</b>	<b>\$ 7,986,970</b>			<b>\$ 6,383,742</b>		
<b>Liabilities and Stockholders' Equity</b>						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 4,220,977	\$ 4,136	0.39%	\$ 3,679,753	\$ 3,711	0.40%
Notes payable and other borrowings	823,947	621	0.30%	384,843	325	0.33%
Total interest-bearing liabilities (3)	5,044,924	4,757	0.37%	4,064,596	4,036	0.39%
Noninterest-bearing liabilities						
Noninterest-bearing deposits	1,823,016			1,409,690		
Other liabilities	45,484			22,858		
Total liabilities	6,913,424			5,497,144		
Stockholders' equity	1,073,546			886,598		
<b>Total liabilities and stockholders' equity</b>	<b>\$ 7,986,970</b>			<b>\$ 6,383,742</b>		
<b>Net interest income (2)</b>		<b>\$ 79,082</b>			<b>\$ 71,463</b>	
<b>Net interest spread (2)</b>			<b>4.50%</b>			<b>4.99%</b>
<b>Net interest margin (2)</b>			<b>4.62%</b>			<b>5.09%</b>

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	Nine Months Ended September 30,					
	Average Outstanding Balance	2014 Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	2013 Interest Earned or Paid	Annualized Yield or Rate
<b>Assets</b>						
Interest-earning assets						
Loans, gross (1)	\$ 4,204,613	\$ 217,892	6.86%	\$ 2,995,848	\$ 163,626	7.22%
Subsidiary warehouse lines of credit	877,791	25,250	3.79%	984,857	41,122	5.51%
Investment securities - taxable	913,732	13,508	1.97%	758,330	10,267	1.81%
Investment securities - non-taxable (2)	151,880	4,434	4.58%	159,671	4,242	4.15%
Federal funds sold and securities purchased under agreements to resell	20,324	43	0.29%	25,111	53	0.28%
Interest-bearing deposits in other financial institutions	531,650	1,019	0.26%	399,980	806	0.27%
Other	43,675	1,298	3.96%	34,818	935	3.58%
Interest-earning assets, gross	6,743,665	263,444	5.19%	5,358,615	221,051	5.47%
Allowance for loan losses (38,752)				(18,730)		
Interest-earning assets, net	6,704,913			5,339,885		
Noninterest-earning assets	1,255,878			830,395		
<b>Total assets</b>	<b>\$ 7,960,791</b>			<b>\$ 6,170,280</b>		
<b>Liabilities and Stockholders Equity</b>						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 4,554,514	\$ 11,034	0.32%	\$ 3,511,243	\$ 10,528	0.40%
Notes payable and other borrowings	592,459	1,340	0.30%	429,728	1,053	0.33%
Total interest-bearing liabilities (3)	5,146,973	12,374	0.32%	3,940,971	11,581	0.39%
Noninterest-bearing liabilities						
Noninterest-bearing deposits	1,743,458			1,313,114		
Other liabilities	32,016			46,581		
Total liabilities	6,922,447			5,300,666		
Stockholders equity	1,038,344			869,614		
<b>Total liabilities and stockholders equity</b>	<b>\$ 7,960,791</b>			<b>\$ 6,170,280</b>		
<b>Net interest income (2)</b>		<b>\$ 251,070</b>			<b>\$ 209,470</b>	
<b>Net interest spread (2)</b>			<b>4.87%</b>			<b>5.08%</b>
<b>Net interest margin (2)</b>			<b>4.98%</b>			<b>5.16%</b>

(1) Average balance includes non-accrual loans.

(2) Annualized taxable equivalent adjustments are based on a 35% tax rate. The adjustment to interest income was \$0.5 million for each of the three months ended September 30, 2014 and 2013, respectively, and \$1.5 million for each of the nine months ended September 30, 2014 and 2013, respectively.

(3) Excludes the allocation of interest expense on PlainsCapital debt of \$0.3 million for each of the three months ended September 30, 2014 and 2013 and \$0.8 million and \$0.8 million for the nine months ended September 30, 2014 and 2013.

The banking segment's net interest margin shown above exceeds our consolidated net interest margin. Our consolidated net interest margin includes the yields and costs associated with certain items within interest-earning assets and interest-bearing liabilities in the financial advisory

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segment, as well as the borrowing costs of Hilltop and PlainsCapital, both of which reduce our consolidated net interest margin. In addition, the banking segment's interest earning assets include lines of credit extended to subsidiaries. Such yields and costs are eliminated from the consolidated financial statements.

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The following tables summarize the changes in the banking segment's net interest income for the periods indicated below, including the component changes in the volume of average interest-earning assets and interest-bearing liabilities and changes in the rates earned or paid on those items (in thousands).

	Three Months Ended September 30, 2014 v. 2013			Nine Months Ended September 30, 2014 v. 2013		
	Change Due To (1)		Change	Change Due To (1)		Change
	Volume	Yield/Rate		Volume	Yield/Rate	
Interest income						
Loans, gross	\$ 17,943	\$ (7,328)	\$ 10,615	\$ 65,419	\$ (11,153)	\$ 54,266
Subsidiary warehouse lines of credit	1,565	(4,383)	(2,818)	(4,421)	(11,451)	(15,872)
Investment securities - taxable	731	(267)	464	2,104	1,137	3,241
Investment securities - non-taxable (2)	(46)	70	24	(243)	435	192
Federal funds sold and securities purchased under agreements to resell	(15)	1	(14)	(10)		(10)
Interest-bearing deposits in other financial institutions	2	(34)	(32)	266	(53)	213
Other	156	(55)	101	238	125	363
Total interest income (2)	20,336	(11,996)	8,340	63,353	(20,960)	42,393