Hilltop Holdings Inc.
Form 10-Q
July 30, 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 June 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	**84-1477939**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
200 Crescent Court, Suite 1330 Dallas, TX	**75201**

(Address of principal executive offices)	(Zip Code)

(214) 855-2177

(Registrant s telephone number, including area code)

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

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 x No o

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	x	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

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

The number of shares of the registrant s common stock outstanding at July 29, 2014 was 90,182,915.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2014

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	June 30, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and due from banks	$ 673,972	$ 713,099
Federal funds sold and securities purchased under agreements to resell	14,813	32,924
Securities:		
Trading, at fair value	61,663	58,846
Available for sale, at fair value (amortized cost of $1,205,912 and $1,256,862, respectively)	1,201,778	1,203,143
Held to maturity, at amortized cost (fair value of $65,631)	65,275	
	1,328,716	1,261,989
Loans held for sale	1,410,873	1,089,039
Non-covered loans, net of unearned income	3,714,837	3,514,646
Allowance for non-covered loan losses	(36,431)	(33,241)
Non-covered loans, net	3,678,406	3,481,405
Covered loans, net of allowance of $4,115 and $1,061, respectively	840,898	1,005,308
Broker-dealer and clearing organization receivables	190,764	119,317
Insurance premiums receivable	27,957	25,597
Deferred policy acquisition costs	22,027	20,991
Premises and equipment, net	201,545	200,706
FDIC indemnification asset	175,114	188,291
Covered other real estate owned	142,174	142,833
Mortgage servicing rights	35,877	20,149
Other assets	336,199	279,745
Goodwill	251,808	251,808
Other intangible assets, net	65,305	70,921
Total assets	$ 9,396,448	$ 8,904,122
Liabilities and Stockholders Equity		
Deposits:		
Noninterest-bearing	$ 1,829,072	$ 1,773,749
Interest-bearing	4,326,238	4,949,169
Total deposits	6,155,310	6,722,918
Broker-dealer and clearing organization payables	227,891	129,678
Reserve for losses and loss adjustment expenses	35,146	27,468
Unearned insurance premiums	94,611	88,422
Short-term borrowings	1,187,193	342,087
Notes payable	55,584	56,327
Junior subordinated debentures	67,012	67,012
Other liabilities	176,539	158,288
Total liabilities	7,999,286	7,592,200
Commitments and contingencies (see Notes 11 and 12)		
Stockholders equity:		
Hilltop stockholders equity:		
	114,068	114,068

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				
Common stock, $0.01 par value, 125,000,000 and 100,000,000 shares authorized; 90,180,699 and 90,175,688 shares issued and outstanding, respectively		902		902
Additional paid-in capital		1,387,883		1,388,641
Accumulated other comprehensive loss		(2,501)		(34,863)
Accumulated deficit		(103,910)		(157,607)
Total Hilltop stockholders equity		1,396,442		1,311,141
Noncontrolling interest		720		781
Total stockholders equity		1,397,162		1,311,922
Total liabilities and stockholders equity	$	9,396,448	$	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 June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Interest income:				
Loans, including fees	$ 92,204	$ 65,213	$ 171,948	$ 130,099
Securities:				
Taxable	7,618	6,480	15,206	12,392
Tax-exempt	1,187	1,189	2,429	2,536
Federal funds sold and securities purchased under agreements to resell	14	35	33	56
Interest-bearing deposits with banks	317	242	912	575
Other	3,068	3,009	5,708	5,114
Total interest income	104,408	76,168	196,236	150,772
Interest expense:				
Deposits	3,096	3,406	6,855	6,856
Short-term borrowings	539	591	934	1,104
Notes payable	632	2,308	1,280	4,630
Junior subordinated debentures	587	612	1,171	1,220
Other	1,108	826	2,129	1,276
Total interest expense	5,962	7,743	12,369	15,086
Net interest income	98,446	68,425	183,867	135,686
Provision for loan losses	5,533	11,289	8,775	24,294
Net interest income after provision for loan losses	92,913	57,136	175,092	111,392
Noninterest income:				
Net gains from sale of loans and other mortgage production income	106,054	142,531	185,165	270,127
Mortgage loan origination fees	16,983	22,695	29,327	41,588
Net insurance premiums earned	40,777	38,590	81,096	76,063
Investment and securities advisory fees and commissions	22,264	25,964	43,599	47,973
Other	17,203	9,453	34,194	16,760
Total noninterest income	203,281	239,233	373,381	452,511
Noninterest expense:				
Employees compensation and benefits	124,445	132,715	230,874	248,905
Loss and loss adjustment expenses	35,275	48,160	53,612	69,345
Policy acquisition and other underwriting expenses	11,652	11,627	23,339	22,430
Occupancy and equipment, net	25,762	20,154	52,100	39,566
Other	54,078	47,744	103,916	95,145
Total noninterest expense	251,212	260,400	463,841	475,391
Income before income taxes	44,982	35,969	84,632	88,512
Income tax expense	16,294	13,309	30,648	32,479

Net income		28,688		22,660		53,984		56,033
Less: Net income attributable to noncontrolling interest		177		568		287		868
Income attributable to Hilltop		28,511		22,092		53,697		55,165
Dividends on preferred stock		1,426		1,149		2,852		1,852
Income applicable to Hilltop common stockholders	$	27,085	$	20,943	$	50,845	$	53,313
Earnings per common share:								
Basic	$	0.30	$	0.25	$	0.56	$	0.64
Diluted	$	0.30	$	0.24	$	0.56	$	0.61
Weighted average share information:								
Basic		89,709		83,490		89,708		83,489
Diluted		90,569		90,294		90,576		90,125

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(Unaudited)

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net income	$ 28,688	$ 22,660	$ 53,984	$ 56,033
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale, net of tax of $7,638, $(15,249), $17,221 and $(14,776)	13,553	(28,320)	32,362	(27,441)
Comprehensive income (loss)	42,241	(5,660)	86,346	28,592
Less: comprehensive income attributable to noncontrolling interest	177	568	287	868
Comprehensive income (loss) applicable to Hilltop	$ 42,064	$ (6,228)	$ 86,059	$ 27,724

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

(Unaudited)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Hilltop Stockholders Equity	Noncontrolling Interest	Total Stockholders Equity
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							55,165	55,165	868	56,033
Other comprehensive loss						(27,441)		(27,441)		(27,441)
Stock-based compensation expense					480			480		480
Common stock issued to board members			4		47			47		47
Issuance of restricted common stock			465	5	(5)					
Dividends on preferred stock					(1,852)			(1,852)		(1,852)
Cash distributions to noncontrolling interest									(2,017)	(2,017)
Balance, June 30, 2013	114	$ 114,068	83,956	$ 840	$ 1,303,118	$ (19,347)	$ (227,784)	$ 1,170,895	$ 905	$ 1,171,800
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							53,697	53,697	287	53,984
Other comprehensive income						32,362		32,362		32,362
Stock-based compensation expense					1,979			1,979		1,979
Common stock issued to board members			5		115			115		115
Dividends on preferred stock					(2,852)			(2,852)		(2,852)
Cash distributions to noncontrolling interest									(348)	(348)
Balance, June 30, 2014	114	$ 114,068	90,181	$ 902	$ 1,387,883	$ (2,501)	$ (103,910)	$ 1,396,442	$ 720	$ 1,397,162

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Operating Activities		
Net income	$ 53,984	$ 56,033
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	8,775	24,294
Depreciation, amortization and accretion, net	(48,612)	(18,032)
Deferred income taxes	4,842	(11,528)
Other, net	2,191	533
Net change in securities purchased under resale agreements		(3,237)
Net change in trading securities	(2,817)	57,256
Net change in broker-dealer and clearing organization receivables	(146,643)	(76,430)
Net change in other assets	(28,818)	34,972
Net change in broker-dealer and clearing organization payables	177,748	17,281
Net change in loss and loss adjustment expense reserve	7,678	8,446
Net change in unearned insurance premiums	6,189	7,813
Net change in other liabilities	4,645	(37,247)
Net gains from sale of loans	(185,165)	(270,127)
Loans originated for sale	(4,927,983)	(6,545,177)
Proceeds from loans sold	4,782,239	6,769,795
Net cash provided by (used in) operating activities	(291,747)	14,645
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	911	
Proceeds from sales, maturities and principal reductions of securities available for sale	97,867	96,069
Purchases of securities held to maturity	(66,207)	
Purchases of securities available for sale	(47,557)	(223,570)
Net change in loans	68,552	(51,027)
Purchases of premises and equipment and other assets	(19,815)	(11,417)
Proceeds from sales of premises and equipment and other real estate owned	38,281	4,859
Net cash paid for Federal Home Loan Bank and Federal Reserve Bank stock	(31,440)	(21,219)
Net cash provided by (used in) investing activities	40,592	(206,305)
Financing Activities		
Net change in deposits	(647,143)	(179,826)
Net change in short-term borrowings	845,106	275,554
Proceeds from notes payable	1,000	
Payments on notes payable	(1,743)	(1,601)
Dividends paid on preferred stock	(2,768)	(703)
Net cash distributed to noncontrolling interest	(348)	(2,017)
Other, net	(187)	(154)
Net cash provided by financing activities	193,917	91,253
Net change in cash and cash equivalents	(57,238)	(100,407)
Cash and cash equivalents, beginning of period	746,023	726,460

Cash and cash equivalents, end of period	$	688,785	$	626,053
Supplemental Disclosures of Cash Flow Information				
Cash paid for interest	$	13,046	$	14,889
Cash paid for income taxes, net of refunds	$	5,582	$	40,949
Supplemental Schedule of Non-Cash Activities				
Conversion of loans to other real estate owned	$	34,391	$	1,718

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 $7.25 per share based on Hilltop s closing price on June 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 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.

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).

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.

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) Accounting Standards Codification (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.

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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.

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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Fair Value Option

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 June 30, 2014, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option was $1.41 billion, and the unpaid principal balance of those loans was $1.35 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.

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
June 30, 2014				
Trading securities	$ 35	$ 61,628	$	$ 61,663
Available for sale securities	24,653	1,113,306	63,819	1,201,778
Loans held for sale		1,400,464	10,409	1,410,873
Derivative assets		35,454		35,454
Mortgage servicing rights asset			35,877	35,877
Trading liabilities		48		48
Derivative liabilities		13,847	6,300	20,147

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value

December 31, 2013				
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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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	Total Gains or Losses (Realized or Unrealized) Included in Net Income	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended June 30, 2014						
Available for sale securities	$ 64,098	$	$	$ 616	$ (895)	$ 63,819
Loans held for sale	26,826	5,522	(24,009)	2,070		10,409
Mortgage servicing rights asset	29,939	7,376		(1,438)		35,877
Derivative liabilities	(5,950)			(350)		(6,300)
Total	$ 114,913	$ 12,898	$ (24,009)	$ 898	$ (895)	$ 103,805
Six months ended June 30, 2014						
Available for sale securities	$ 60,053	$	$	$ 1,209	$ 2,557	$ 63,819
Loans held for sale	27,729	10,422	(29,603)	1,861		10,409
Mortgage servicing rights asset	20,149	14,808		920		35,877
Derivative liabilities	(5,600)			(700)		(6,300)
Total	$ 102,331	$ 25,230	$ (29,603)	$ 3,290	$ 2,557	$ 103,805
Three months ended June 30, 2013						
Available for sale securities	$ 58,801	$	$	$ 531	$ (3,822)	$ 55,510
Mortgage servicing rights asset	4,430	2,180		501		7,111
Derivative liabilities	(4,714)			(225)		(4,939)
Total	$ 58,517	$ 2,180	$	$ 807	$ (3,822)	$ 57,682
Six months ended June 30, 2013						
Available for sale securities	$ 56,277	$	$	$ 1,043	$ (1,810)	$ 55,510
Mortgage servicing rights asset	2,080	4,305		726		7,111
Derivative liabilities	(4,490)			(449)		(4,939)
Total	$ 53,867	$ 4,305	$	$ 1,320	$ (1,810)	$ 57,682

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 June 30, 2014. The available for sale securities noted in the table above reflect Hilltop s note receivable and warrant to purchase common stock of SWS as discussed in Note 4 to the consolidated financial statements.

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

Financial instrument	Valuation Technique	Unobservable Input	Weighted Average / Range
Available for sale securities - note receivable	Discounted cash flow	Discount rate	8.3%
Available for sale securities - warrant	Binomial model	SWS common stock price volatility	24.0%
Loans held for sale	Discounted cash flow / Market comparable	Projected price	86 - 90%
Mortgage servicing rights asset	Discounted cash flow	Constant prepayment rate	10.32%
		Discount rate	11.11%
Derivative liabilities	Discounted cash flow	Discount rate	14 - 28%
		Time to receive full payment of cash flows	10.75 - 14.0 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The 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 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.

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.

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 June 30, 2014			**Three Months Ended June 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	$ 35,651	$	$ 35,651	$ (36,203)	$	$ (36,203)
Mortgage servicing rights asset	(1,438)		(1,438)	501		501
Time deposits					4	4

Changes in Fair Value for Assets and Liabilities Reported at Fair Value under Fair Value Option

Six Months Ended June 30, 2014 **Six Months Ended June 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	$ 40,169	$	$ 40,169	$ (41,641)	$	$ (41,641)
Mortgage servicing asset	920		920	726		726
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 June 30, 2014, these inputs included estimated weighted average default rates, loss severity rates and prepayment speed assumptions of 51%, 45% and 0%, respectively, for those PCI loans acquired in the PlainsCapital Merger and 62%, 39% and 7%, respectively, for those PCI loans acquired in the FNB Transaction. The resulting weighted average expected loss on PCI loans associated with the PlainsCapital Merger and the FNB Transaction was 23% and 24%, respectively.

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(Unaudited)

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 June 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 June 30, 2014 and December 31, 2013, the estimated fair value of covered OREO was $142.2 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 June 30, 2014 and December 31, 2013 was $4.4 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).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value	Total Gains (Losses) for the Three Months Ended June 30, 2014	2013	Total Gains (Losses) for the Six Months Ended June 30, 2014	2013
June 30, 2014								
Non-covered impaired loans	$	$	$ 29,993	$ 29,993	$ (222)	$ (228)	$ (437)	$ (659)
Covered impaired loans			133,325	133,325	(1,341)		(3,032)	
Non-covered other real estate owned					(9)	(30)	(111)	(190)
Covered other real estate owned		18,186	34,126	52,312	(2,528)		(2,959)	

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

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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).

		Estimated Fair Value			
	Carrying Amount	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total**
June 30, 2014					
Financial assets:					
Cash and cash equivalents	$ 688,785	$ 688,785	$	$	$ 688,785
Held to maturity securities	65,275		65,631		65,631
Non-covered loans, net	3,678,406		356,907	3,346,987	3,703,894
Covered loans, net	840,898			902,588	902,588
Broker-dealer and clearing organization receivables	190,764		190,764		190,764
FDIC indemnification asset	175,114			175,114	175,114
Other assets	63,843		42,383	21,460	63,843
Financial liabilities:					
Deposits	6,155,310		6,160,913		6,160,913
Broker-dealer and clearing organization payables	227,891		227,891		227,891
Short-term borrowings	1,187,193		1,187,193		1,187,193
Debt	122,596		115,856		115,856
Other liabilities	2,834		2,834		2,834

		Estimated Fair Value			
	Carrying Amount	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total**
December 31, 2013					
Financial assets:					
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
Financial liabilities:					
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).

	Available for Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2014				
U.S. Treasury securities	$ 63,692	$ 164	$ (34)	$ 63,822
U.S. government agencies:				
Bonds	654,513	1,485	(20,899)	635,099
Residential mortgage-backed securities	55,895	2,008	(399)	57,504
Collateralized mortgage obligations	110,909	302	(4,081)	107,130
Corporate debt securities	95,704	5,659	(108)	101,255
States and political subdivisions	148,255	1,470	(1,894)	147,831
Commercial mortgage-backed securities	597	68		665
Equity securities	20,396	4,257		24,653
Note receivable	43,883	6,038		49,921
Warrant	12,068	1,830		13,898
Totals	$ 1,205,912	$ 23,281	$ (27,415)	$ 1,201,778

	Available for Sale			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2013				
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

	Held to Maturity		
	Amortized	Unrealized	Unrealized

	Cost	Gains	Losses	Fair Value
June 30, 2014				
U.S. government agencies:				
Residential mortgage-backed securities	$ 31,048	$ 384	$ (1)	$ 31,431
Collateralized mortgage obligations	29,821		(14)	29,807
States and political subdivisions	4,406	7	(20)	4,393
Totals	$ 65,275	$ 391	$ (35)	$ 65,631

Available for sale securities includes 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. SWS issued the note in July 2011 under a credit agreement pursuant to a senior unsecured loan from Hilltop. The note bears interest at a rate of 8.0% per annum, is prepayable by SWS subject to certain conditions after three years, and has a maturity of five years. The warrant provides 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. If the warrant was fully exercised, Hilltop would beneficially own 24.4% of SWS.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	June 30, 2014			December 31, 2013		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Available for Sale						
U.S. treasury securities:						
Unrealized loss for less than twelve months	3	$ 6,396	$ 26	6	$ 12,748	$ 238
Unrealized loss for twelve months or longer	1	2,010	8			
	4	8,406	34	6	12,748	238
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	1	9,987	13	35	526,817	45,274
Unrealized loss for twelve months or longer	31	487,164	20,886	5	90,931	10,453
	32	497,151	20,899	40	617,748	55,727
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	1	1,593	58	2	2,194	54
Unrealized loss for twelve months or longer	3	9,356	341	3	9,309	530
	4	10,949	399	5	11,503	584
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	2	13,128	24	7	84,054	4,320
Unrealized loss for twelve months or longer	8	68,301	4,057	2	4,995	70
	10	81,429	4,081	9	89,049	4,390
Corporate debt securities:						
Unrealized loss for less than twelve months				7	10,754	378
Unrealized loss for twelve months or longer	1	1,889	108			
	1	1,889	108	7	10,754	378
States and political subdivisions:						
Unrealized loss for less than twelve months	12	8,846	49	46	30,245	669
Unrealized loss for twelve months or longer	119	80,555	1,845	150	96,882	5,839
	131	89,401	1,894	196	127,127	6,508
Total available for sale:						
Unrealized loss for less than twelve months	19	39,950	170	103	666,812	50,933
Unrealized loss for twelve months or longer	163	649,275	27,245	160	202,117	16,892
	182	$ 689,225	$ 27,415	263	$ 868,929	$ 67,825

	June 30, 2014			December 31, 2013		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Held to Maturity						
U.S. government agencies:						
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	1	$ 2,029	$ 1		$	$
Unrealized loss for twelve months or longer						
	1	2,029	1			
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	1	29,807	14			
Unrealized loss for twelve months or longer						
	1	29,807	14			
States and political subdivisions:						
Unrealized loss for less than twelve months	6	3,327	20			
Unrealized loss for twelve months or longer						
	6	3,327	20			
Total held to maturity:						
Unrealized loss for less than twelve months	8	35,163	35			
Unrealized loss for twelve months or longer						
	8	$ 35,163	$ 35		$	$

During the three and six months ended June 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

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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 June 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 warrant, at June 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	$ 133,456	$ 133,611	$	$
Due after one year through five years	120,411	130,803		
Due after five years through ten years	71,929	74,513	264	264
Due after ten years	680,251	659,001	4,142	4,129
	1,006,047	997,928	4,406	4,393
Residential mortgage-backed securities	55,895	57,504	31,048	31,431
Collateralized mortgage obligations	110,909	107,130	29,821	29,807
Commercial mortgage-backed securities	597	665		
	$ 1,173,448	$ 1,163,227	$ 65,275	$ 65,631

The Company realized net gains from its trading securities portfolio of $0.8 million and $1.4 million during the three and six months ended June 30, 2014, respectively, and net losses of $1.5 million and $2.7 million during the three and six months ended June 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 $1.0 billion (with a fair value of $983.1 million and $938.1 million, respectively) at both June 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.

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 June 30, 2014 and December 31, 2013, NLC had investments on deposit in custody for various state insurance departments with carrying values of $8.6 million and $9.4 million, respectively.

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Notes to Consolidated Financial Statements (continued)

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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).

	June 30, 2014	December 31, 2013
Commercial and industrial	$ 1,681,655	$ 1,637,266
Real estate	1,586,535	1,457,253
Construction and land development	391,611	364,551
Consumer	55,036	55,576
	3,714,837	3,514,646
Allowance for non-covered loan losses	(36,431)	(33,241)
Total non-covered loans, net of allowance	$ 3,678,406	$ 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.

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).

	June 30, 2014	December 31, 2013
Carrying amount	$ 60,787	$ 100,392
Outstanding balance	83,534	141,983

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 June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Balance, beginning of period	$ 17,713	$ 26,246	$ 17,601	$ 17,553
Increases in expected cash flows	6,141	141	9,616	12,137
Disposals of loans	(3,581)	(1,806)	(4,184)	(1,832)
Accretion	(8,369)	(4,463)	(11,129)	(7,740)
Balance, end of period	$ 11,904	$ 20,118	$ 11,904	$ 20,118

The remaining nonaccretable difference for non-covered PCI loans was $24.0 million and $38.6 million at June 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).

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
June 30, 2014					
Commercial and industrial:					
Secured	$ 50,056	$ 9,060	$ 15,514	$ 24,574	$ 3,268
Unsecured	5,411	504		504	
Real estate:					
Secured by commercial properties	31,715	10,286	14,116	24,402	492
Secured by residential properties	5,896	2,898	1,199	4,097	59
Construction and land development:					
Residential construction loans					
Commercial construction loans and land development	17,731	10,313	553	10,866	65
Consumer	6,852	483	2,606	3,089	111
	$ 117,661	$ 33,544	$ 33,988	$ 67,532	$ 3,995

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
December 31, 2013					
Commercial and industrial:					
Secured	$ 63,636	$ 21,540	$ 17,147	$ 38,687	$ 3,126
Unsecured	11,865	336	1,204	1,540	15
Real estate:					
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
Construction and land development:					
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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(Unaudited)

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

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Commercial and industrial:				
Secured	$ 29,852	$ 61,715	$ 31,631	$ 61,365
Unsecured	865	2,385	1,022	2,697
Real estate:				
Secured by commercial properties	27,120	49,687	30,395	51,835
Secured by residential properties	4,541	7,131	3,745	6,446
Construction and land development:				
Residential construction loans				354
Commercial construction loans and land development	13,313	26,681	15,398	29,776
Consumer	3,410	69	3,799	72
	$ 79,101	$ 147,668	$ 85,990	$ 152,545

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

	June 30, 2014	December 31, 2013
Commercial and industrial:		
Secured	$ 14,258	$ 15,430
Unsecured	504	1,300
Real estate:		
Secured by commercial properties	485	2,638
Secured by residential properties	1,887	398
Construction and land development:		
Residential construction loans		
Commercial construction loans and land development	863	112
Consumer		
	$ 17,997	$ 19,878

At June 30, 2014 and December 31, 2013, non-covered non-accrual loans included non-covered PCI loans of $11.3 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, $3.9 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 June 30, 2014 and December 31, 2013, respectively.

Interest income recorded on non-covered accruing impaired loans and on non-covered non-accrual loans was $1.1 million and $2.5 million for the three and six months ended June 30, 2014, respectively. Interest income recorded on non-covered accruing impaired loans and on non-covered non-accrual loans for the three and six months ended June 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

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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 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 June 30, 2014. At June 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.

Six months ended June 30, 2014				
Commercial and industrial:				
Secured	$	$	$	$
Unsecured				
Real estate:				
Secured by commercial properties			336	336
Secured by residential properties			258	258
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development			138	138
Consumer				
	$	$	$ 732	$ 732

Three months ended June 30, 2013				
Commercial and industrial:				
Secured	$	$	$ 9,853	$ 9,853
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				
	$	$	$ 9,853	$ 9,853

	Recorded Investment in Loans Modified by			
	A/B Note	Interest Rate Adjustment	Payment Term Extension	Total Modification
Six months ended June 30, 2013				
Commercial and industrial:				
Secured	$	$	$ 9,858	$ 9,858
Unsecured				
Real estate:				
Secured by commercial properties			272	272
Secured by residential properties			1,047	1,047
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development			603	603
Consumer				
	$	$	$ 11,780	$ 11,780

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

[redacted]								
June 30, 2014								
[redacted]								
Secured	$ 14,705	$ 891	$ 1,690	$ 17,286	$ 1,545,510	$ 21,086	$ 1,583,882	$ 1
[redacted]								
Real estate:								
[redacted]								
Secured by residential properties	482	1,090	467	2,039	455,149	2,304	459,492	
[redacted]								
Residential construction loans	2,176			2,176	68,280		70,456	
[redacted]								
Consumer	241	55		296	51,651	3,089	55,036	
[redacted]								

	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
December 31, 2013								
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
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).

	Pass	Special Mention	Substandard	PCI	Total
June 30, 2014					
Commercial and industrial:					
Secured	$ 1,522,487	$ 18,277	$ 22,032	$ 21,086	$ 1,583,882
Unsecured	97,118		267	388	97,773
Real estate:					
Secured by commercial properties	1,097,299	4,369	1,458	23,917	1,127,043
Secured by residential properties	451,931		5,257	2,304	459,492
Construction and land development:					
Residential construction loans	70,456				70,456
Commercial construction loans and land development	309,614	274	1,264	10,003	321,155
Consumer	51,898		49	3,089	55,036
	$ 3,600,803	$ 22,920	$ 30,327	$ 60,787	$ 3,714,837

	Pass	Special Mention	Substandard	PCI	Total
December 31, 2013					
Commercial and industrial:					
Secured	$ 1,450,734	$ 16,840	$ 29,021	$ 35,372	$ 1,531,967
Unsecured	103,674	12	169	1,444	105,299
Real estate:					
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
Construction and land development:					
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

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.

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 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

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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 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 June 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 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).

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Three months ended June 30, 2014					
Balance, beginning of period	$ 16,726	$ 9,682	$ 8,096	$ 141	$ 34,645
Provision charged to operations	3,631	306	(51)	197	4,083
Loans charged off	(2,924)	(72)		(85)	(3,081)
Recoveries on charged off loans	629	82	41	32	784
Balance, end of period	$ 18,062	$ 9,998	$ 8,086	$ 285	$ 36,431

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Six months ended June 30, 2014					
Balance, beginning of period	$ 16,865	$ 8,331	$ 7,957	$ 88	$ 33,241
Provision charged to operations	3,574	1,625	(34)	306	5,471
Loans charged off	(3,731)	(72)		(159)	(3,962)
Recoveries on charged off loans	1,354	114	163	50	1,681
Balance, end of period	$ 18,062	$ 9,998	$ 8,086	$ 285	$ 36,431

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Three months ended June 30, 2013					
Balance, beginning of period	$ 8,812	$ 3,522	$ 4,286	$ 17	$ 16,637
Provision charged to operations	6,729	1,820	2,720	20	11,289

Loans charged off		(3,656)		(65)				(15)		(3,736)
Recoveries on charged off loans		1,921		62		44		20		2,047
Balance, end of period	$	13,806	$	5,339	$	7,050	$	42	$	26,237

		Commercial and Industrial		Real Estate		Construction and Land Development		Consumer		Total
Six months ended June 30, 2013										
Balance, beginning of period	$	1,845	$	977	$	582	$	5	$	3,409
Provision charged to operations		13,640		4,257		6,317		80		24,294
Loans charged off		(4,094)		(96)				(71)		(4,261)
Recoveries on charged off loans		2,415		201		151		28		2,795
Balance, end of period	$	13,806	$	5,339	$	7,050	$	42	$	26,237

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

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
June 30, 2014					
Loans individually evaluated for impairment	$ 2,487	$ 1,973	$ 863	$	$ 5,323
Loans collectively evaluated for impairment	1,657,694	1,558,341	380,745	51,947	3,648,727
PCI Loans	21,474	26,221	10,003	3,089	60,787
	$ 1,681,655	$ 1,586,535	$ 391,611	$ 55,036	$ 3,714,837

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
December 31, 2013					
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).

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
June 30, 2014					
Loans individually evaluated for impairment	$ 421	$	$	$	$ 421
Loans collectively evaluated for impairment	14,794	9,447	8,021	174	32,436
PCI Loans	2,847	551	65	111	3,574
	$ 18,062	$ 9,998	$ 8,086	$ 285	$ 36,431

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
December 31, 2013					
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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Covered Loans and Allowance for Covered Loan Losses

Loans acquired in a FDIC-assisted acquisition 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).

	June 30, 2014	December 31, 2013
Commercial and industrial	$ 50,016	$ 66,943
Real estate	698,225	787,982
Construction and land development	96,772	151,444
Consumer		
Total covered loans	845,013	1,006,369
Allowance for covered loans	(4,115)	(1,061)
Total covered loans, net of allowance	$ 840,898	$ 1,005,308

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

	June 30, 2014	December 31, 2013

Carrying amount	$	595,218	$	729,156
Outstanding balance		874,589		1,022,514

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

	Three Months Ended June 30, 2014		Six Months Ended June 30, 2014	
Balance, beginning of period	$	176,469	$	156,548
Increases in expected cash flows		26,871		57,581
Transfer of loans to covered OREO		111		5,372
Accretion		(17,310)		(33,360)
Balance, end of period	$	186,141	$	186,141

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The remaining nonaccretable difference for covered PCI loans was $389.7 million and $517.9 million at June 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).

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
June 30, 2014					
Commercial and industrial:					
Secured	$ 32,119	$ 11,877	$ 7,051	$ 18,928	$ 108
Unsecured	16,091	3,124	5,284	8,408	883
Real estate:					
Secured by commercial properties	480,651	221,909	93,668	315,577	1,186
Secured by residential properties	269,049	159,048	16,820	175,868	1,355
Construction and land development:					
Residential construction loans	4,929	1,905	1,170	3,075	5
Commercial construction loans and land development	137,053	65,337	13,246	78,583	377
Consumer					
	$ 939,892	$ 463,200	$ 137,239	$ 600,439	$ 3,914

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
December 31, 2013					
Commercial and industrial:					
Secured	$ 43,957	$ 28,611	$	$ 28,611	$
Unsecured	16,280	9,008	882	9,890	882
Real estate:					
Secured by commercial properties	528,825	365,346		365,346	
Secured by residential properties	289,094	199,581		199,581	
Construction and land development:					
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).

	Three Months Ended June 30, 2014		Six Months Ended June 30, 2014	
Commercial and industrial:				
Secured	$	20,585	$	23,770
Unsecured		8,688		9,149
Real estate:				
Secured by commercial properties		327,508		340,462
Secured by residential properties		182,264		187,725
Construction and land development:				
Residential construction loans		3,669		4,178
Commercial construction loans and land development		84,800		99,973
Consumer				
	$	627,514	$	665,257

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

	June 30, 2014	December 31, 2013
Commercial and industrial:		
Secured	$ 1,141	$ 91
Unsecured	954	882
Real estate:		
Secured by commercial properties	10,910	40
Secured by residential properties	1,710	209
Construction and land development:		
Residential construction loans	1,905	575
Commercial construction loans and land development	14	
Consumer		
	$ 16,634	$ 1,797

At June 30, 2014, covered non-accrual loans included covered PCI loans of $11.4 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 six months ended June 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).

	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
June 30, 2014								
Commercial and industrial:								
Secured	$	$ 915	$ 226	$ 1,141	$ 21,293	$ 17,787	$ 40,221	$
Unsecured	1,000		71	1,071	387	8,337	9,795	
Real estate:								
Secured by commercial properties	580	100	609	1,289	56,520	315,197	373,006	229
Secured by residential properties	1,298	764	1,137	3,199	147,862	174,158	325,219	43

Construction and land development:								
Residential construction loans			1,905	1,905	1,093	1,170	4,168	
Commercial construction loans and land development	57	227		284	13,751	78,569	92,604	
Consumer								
	$ 2,935	$ 2,006	$ 3,948	$ 8,889	$ 240,906	$ 595,218	$ 845,013	$ 272

	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
December 31, 2013								
Commercial and industrial:	$ 3,904	$ 10	$ 81	$ 3,995	$ 20,918	$ 28,520	$ 53,433	$
Secured	10	259		269	3,351	9,890	13,510	
Unsecured								
Real estate:	999		40	1,039	63,780	365,306	430,125	
Secured by commercial properties	1,679	678	209	2,566	155,919	199,372	357,857	
Secured by residential properties								
Construction and land development:	1,861		576	2,437	5,026	4,705	12,168	
Residential construction loans	244	20		264	17,649	121,363	139,276	
Commercial construction loans and land development								
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).

	Pass	Special Mention	Substandard	PCI	Total
June 30, 2014					
Commercial and industrial:					
Secured	$ 15,233	$	$ 7,201	$ 17,787	$ 40,221
Unsecured	156		1,302	8,337	9,795
Real estate:					
Secured by commercial properties	47,299	1,681	8,829	315,197	373,006
Secured by residential properties	143,451		7,610	174,158	325,219
Construction and land development:					
Residential construction loans	1,093		1,905	1,170	4,168
Commercial construction loans and land development	11,527		2,508	78,569	92,604
Consumer					