Hilltop Holdings Inc.
Form 10-Q
May 06, 2013
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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 March 31, 2013

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)	**84-1477939** (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 o	Accelerated filer x
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 May 3, 2013 was 83,955,870.

HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2013

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	March 31, 2013 (Unaudited)	December 31, 2012
Assets		
Cash and due from banks	$ 588,838	$ 722,039
Federal funds sold and securities purchased under agreements to resell	23,691	4,421
Securities:		
Trading, at fair value	60,769	90,113
Available for sale, at fair value (amortized cost of $1,132,701 and $978,502, respectively)	1,146,505	990,953
	1,207,274	1,081,066
Loans held for sale	1,242,322	1,401,507
Loans, net of unearned income	3,248,367	3,152,396
Allowance for loan losses	(16,637)	(3,409)
Loans, net	3,231,730	3,148,987
Broker-dealer and clearing organization receivables	187,833	145,564
Insurance premiums receivable	24,924	24,615
Deferred policy acquisition costs	20,301	19,812
Reinsurance receivable, net of uncollectible amounts	18,210	18,567
Premises and equipment, net	111,894	111,381
Other assets	233,033	277,398
Goodwill	251,808	253,770
Other intangible assets, net	75,052	77,738
Total assets	$ 7,216,910	$ 7,286,865
Liabilities and Stockholders Equity		
Deposits:		
Noninterest-bearing	$ 249,678	$ 323,367
Interest-bearing	4,508,760	4,377,094
Total deposits	4,758,438	4,700,461
Broker-dealer and clearing organization payables	250,280	187,990
Reserve for losses and loss adjustment expenses	32,070	34,012
Unearned insurance premiums	84,032	82,598
Short-term borrowings	576,730	728,250
Notes payable	140,747	141,539
Junior subordinated debentures	67,012	67,012
Other liabilities	129,016	198,453
Total liabilities	6,038,325	6,140,315
Commitments and contingencies (see Notes 9 and 10)		
Stockholders equity:		
Hilltop Holdings 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, respectively	114,068	114,068
Common stock, $0.01 par value, 100,000,000 shares authorized; 83,487,340 shares issued and outstanding, respectively	835	835

Additional paid-in capital	1,304,771	1,304,707
Accumulated other comprehensive income	8,973	8,094
Accumulated deficit	(250,838)	(283,208)
Total Hilltop Holdings stockholders equity	1,177,809	1,144,496
Noncontrolling interest	776	2,054
Total stockholders equity	1,178,585	1,146,550
Total liabilities and stockholders equity	$ 7,216,910	$ 7,286,865

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 March 31, 2013	2012
Interest income:		
Loans, including fees	$ 64,886	$
Securities:		
Taxable	5,863	3,355
Tax-exempt	1,347	
Federal funds sold and securities purchased under agreements to resell	21	
Interest-bearing deposits with banks	333	
Other	2,105	
Total interest income	74,555	3,355
Interest expense:		
Deposits	3,450	
Short-term borrowings	513	
Notes payable	2,322	2,139
Junior subordinated debentures	608	
Other	450	
Total interest expense	7,343	2,139
Net interest income	67,212	1,216
Provision for loan losses	13,005	
Net interest income after provision for loan losses	54,207	1,216
Noninterest income:		
Net gains from sale of loans and other mortgage production income	127,596	
Mortgage loan origination fees	18,893	
Net insurance premiums earned	37,473	35,155
Investment and securities advisory fees and commissions	22,009	
Other	7,356	1,732
Total noninterest income	213,327	36,887
Noninterest expense:		
Employees compensation and benefits	116,190	2,226
Loss and loss adjustment expenses	21,185	22,542
Policy acquisition and other underwriting expenses	10,803	10,901
Occupancy and equipment, net	19,412	244
Other	47,401	1,644
Total noninterest expense	214,991	37,557
Income before income taxes	52,543	546
Income tax expense	19,170	203
Net income	33,373	343
Less: Net income attributable to noncontrolling interest	300	

Income attributable to Hilltop Holdings		33,073		343
Dividends on preferred stock		703		
Income applicable to Hilltop Holdings common stockholders	$	32,370	$	343
Earnings per common share:				
Basic	$	0.39	$	0.01
Diluted	$	0.39	$	0.01
Weighted average share information:				
Basic		83,487		56,499
Diluted		83,743		56,555

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(Unaudited)

	Three Months Ended March 31, 2013		Three Months Ended March 31, 2012	
Net income	$	33,373	$	343
Other comprehensive income (loss):				
Unrealized gains (losses) on securities available for sale, net of tax of $473 and $(1,831)		879		(3,401)
Comprehensive income (loss)		34,252		(3,058)
Less: comprehensive income attributable to noncontrolling interest		300		
Comprehensive income (loss) applicable to Hilltop Holdings	$	33,952	$	(3,058)

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	Accumulated Deficit	Total Hilltop Holdings Stockholders Equity	Noncontrolling Interest	Total Stockholders Equity
Balance, December 31, 2011		$	56,501	$ 565	$ 918,192	$ 13,983	$ (277,357)	$ 655,383	$	$ 655,383
Net income							343	343		343
Other comprehensive loss						(3,401)		(3,401)		(3,401)
Common stock issued to board members			1		12			12		12
Repurchase and retirement of common stock			(141)	(1)	(1,161)			(1,162)		(1,162)
Stock-based compensation expense					122			122		122
Balance, March 31, 2012		$	56,361	$ 564	$ 917,165	$ 10,582	$ (277,014)	$ 651,297	$	$ 651,297
Balance, December 31, 2012	114	$ 114,068	83,487	$ 835	$ 1,304,707	$ 8,094	$ (283,208)	$ 1,144,496	$ 2,054	$ 1,146,550
Net income							33,073	33,073	300	33,373
Other comprehensive income						879		879		879
Stock-based compensation expense					64			64		64
Dividends on preferred stock							(703)	(703)		(703)
Cash distributions to noncontrolling interest									(1,578)	(1,578)
Balance, March 31, 2013	114	$ 114,068	83,487	$ 835	$ 1,304,771	$ 8,973	$ (250,838)	$ 1,177,809	$ 776	$ 1,178,585

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Three Months Ended March 31, 2013	2012
Operating Activities		
Net income	$ 33,373	$ 343
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	13,005	
Depreciation, amortization and accretion, net	(9,548)	339
Deferred income taxes	(7,067)	174
Other, net	85	179
Net change in securities purchased under resale agreements	(3,254)	
Net change in trading securities	29,344	
Net change in prepaid FDIC assessments	625	
Net change in broker-dealer and clearing organization receivables	(77,077)	
Net change in assets segregated for regulatory purposes	19,000	
Net change in other assets	27,937	(1,481)
Net change in broker-dealer and clearing organization payables	34,075	
Net change in loss and loss adjustment expense reserve	(1,942)	3,026
Net change in unearned insurance premiums	1,434	2,135
Net change in other liabilities	(56,899)	(2,161)
Net gains from sale of loans	(127,596)	
Loans originated for sale	(3,025,709)	
Proceeds from loans sold	3,310,115	
Net cash provided by operating activities	159,901	2,554
Investing Activities		
Proceeds from sales, maturities and principal reductions of securities available for sale	53,759	2,345
Purchases of securities available for sale	(209,507)	(2,556)
Net change in loans	(41,872)	
Purchases of premises and equipment and other assets	(5,041)	(62)
Proceeds from sales of premises and equipment and other real estate owned	3,880	
Net cash received for Federal Home Loan Bank and Federal Reserve Bank stock	6,702	
Net cash used in investing activities	(192,079)	(273)
Financing Activities		
Net change in deposits	68,948	
Net change in short-term borrowings	(151,520)	
Payments on notes payable	(792)	
Payments to repurchase common stock		(1,162)
Net cash distributed to noncontrolling interest	(1,578)	
Other, net	(65)	
Net cash used in financing activities	(85,007)	(1,162)
Net change in cash and cash equivalents	(117,185)	1,119
Cash and cash equivalents, beginning of period	726,460	578,520
Cash and cash equivalents, end of period	$ 609,275	$ 579,639

Supplemental Disclosures of Cash Flow Information				
Cash paid for interest	$	8,313	$	3,667
Cash paid for income taxes, net of refunds	$	2,205	$	
Supplemental Schedule of Non-Cash Activities				
Conversion of loans to other real estate owned	$	284	$	

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 or the Company) is a holding company that endeavors to make acquisitions or effect business combinations. In connection with this strategy, on November 30, 2012, Hilltop became a financial holding company registered under the Bank Holding Company Act of 1956, as amended by the Gramm-Leach-Bliley Act of 1999, and acquired PlainsCapital Corporation pursuant to an agreement and plan of merger whereby PlainsCapital Corporation merged with and into our wholly owned subsidiary (the Merger), which survived the Merger under the name PlainsCapital Corporation (PlainsCapital).

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. Certain disclosures within the notes to consolidated financial statements are specific to financial products and services of PlainsCapital and its subsidiaries and, therefore include information at March 31, 2013 and December 31, 2012 and relating to the three months ended March 31, 2013.

Prior to the consummation of the Merger, Hilltop s primary operations were limited to providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States through Hilltop s wholly owned property and casualty insurance holding company, NLASCO, Inc. (NLASCO).

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 (consisting primarily of normal recurring accruals) 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, 2012. 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 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, reserves for losses and loss adjustment expenses, the mortgage loan indemnification liability and the potential impairment of assets are particularly subject to change.

The presentation of Hilltop s historical consolidated financial statements has been modified and certain items in the prior period financial statements have been reclassified to conform to the current period presentation, which is more consistent with that of a financial institution that provides an array of financial products and services.

Hilltop owns 100% of the outstanding stock of PlainsCapital. PlainsCapital owns 100% of the outstanding stock of PlainsCapital Bank (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), PNB Aero Services, Inc. and PCB-ARC, Inc. The Bank has a 100% membership interest in First Southwest Holdings, LLC (First Southwest) and PlainsCapital Securities, LLC, as well as a 51% voting interest in PlainsCapital Insurance Services, LLC.

Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Hilltop also owns 100% of NLASCO, 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). Through a series limited liability company structure, Ventures establishes one or more separate operating divisions with select business partners, such as home builders, to originate residential mortgage loans.

The principal subsidiaries of First Southwest are First Southwest Company (FSC), a broker-dealer registered with the SEC and the Financial Industry Regulatory Authority (FINRA), 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 stock 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. PlainsCapital Acquisition

After the close of business on November 30, 2012, Hilltop acquired PlainsCapital Corporation in a stock and cash transaction. PlainsCapital Corporation merged with and into Meadow Corporation, a wholly owned subsidiary of Hilltop, with Meadow Corporation continuing as the surviving entity under the name PlainsCapital Corporation . Based on Hilltop s closing stock price on November 30, 2012, the total purchase price was $813.5 million, consisting of 27.1 million shares of common stock, $311.8 million in cash and the issuance of 114,068 shares of Hilltop Non-Cumulative Perpetual Preferred Stock, Series B. The fair market value of assets acquired, excluding goodwill, totaled $6.5 billion, including $3.2 billion of loans, $730.8 million of investment securities and $70.7 million of identifiable intangibles. The fair market value of the liabilities assumed was $5.9 billion, including $4.5 billion of deposits.

The Merger 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 acquisition date fair values. The Company initially recorded $230.1 million of goodwill in connection with the Merger, representing the inherent long-term value expected from the business opportunities created from combining PlainsCapital with Hilltop. The amount of goodwill recorded in connection with the Company s acquisition of PlainsCapital Corporation is not deductible for tax purposes. The Company used significant estimates and assumptions to value the identifiable assets acquired and liabilities assumed. The purchase date valuations are considered preliminary and are subject to change for up to one year after the acquisition date. During the three months ended March 31, 2013, the Company reduced goodwill related to the PlainsCapital acquisition by $2.0 million for a purchase accounting adjustment related to the valuation of a capital lease obligation.

The operations acquired in the Merger have been included in Hilltop s financial results since December 1, 2012. The following table presents pro forma results for the three months ended March 31, 2012 had the acquisition taken place on January 1, 2011 (in thousands). The pro forma financial information combines the historical results of Hilltop and PlainsCapital Corporation and includes the estimated impact of purchase accounting adjustments. The purchase accounting adjustments reflect the impact of recording the acquired loans at fair value, including the estimated accretion of the purchase discount on the loan portfolio and related adjustments to PlainsCapital s provision for loan losses. Accretion estimates were based on the acquisition date purchase discount on the loan portfolio, as it was not practicable to determine the amount of discount that would have been recorded based on economic conditions that existed on January 1, 2011. The pro forma results do not include any potential operating cost savings as a result of the Merger. Further, certain

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

costs associated with any restructuring or integration activities are also not reflected in the pro forma results. Pro forma results include the acquisition-related merger and restructuring charges incurred during the period. The pro forma results are not indicative of what would have occurred had the acquisition taken place on the indicated date.

	Three Months Ended March 31, 2012	
Net interest income	$	53,542
Other revenues		186,993
Net income		22,687

3. Fair Value Measurements

Fair Value Measurements and Disclosures

Hilltop 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

Hilltop has elected to measure substantially all of PrimeLending s mortgage loans held for sale and certain time deposits at fair value under the provisions of the Fair Value Option. Hilltop 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. Hilltop 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 March 31, 2013, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option was $1.24 billion, while the unpaid principal balance of those loans was $1.20 billion. At December 31, 2012, the aggregate fair value of PrimeLending s mortgage loans held for sale accounted for under the Fair Value Option

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

was $1.40 billion, while the unpaid principal balance of those loans was $1.36 billion. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

Hilltop holds a number of financial instruments that are measured at fair value on a recurring basis, either by the application of 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, data from independent pricing services and rates paid in the brokered certificate of deposit market.

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

March 31, 2013	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total Fair Value**
Cash and cash equivalents	$ 612,529	$	$	$ 612,529
Trading securities		60,769		60,769
Available for sale securities	21,961	1,065,743	58,801	1,146,505
Loans held for sale		1,241,578		1,241,578
Derivative assets		22,600		22,600
Mortgage servicing asset			4,430	4,430
Time deposits		1,066		1,066
Trading liabilities		52		52
Derivative liabilities		7,481		7,481

December 31, 2012	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**	**Total Fair Value**
Cash and cash equivalents	$ 726,460	$	$	$ 726,460
Trading securities		90,113		90,113
Available for sale securities	20,428	914,248	56,277	990,953
Loans held for sale		1,400,737		1,400,737
Derivative assets		15,697		15,697
Mortgage servicing asset			2,080	2,080
Time deposits		1,073		1,073
Trading liabilities		3,164		3,164
Derivative liabilities		1,080		1,080

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

Total Gains or Losses

	Balance at Beginning of Period	Purchases	Issuances	(Realized or Unrealized) Included in Net Income (Loss)	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended March 31, 2013						
Available for sale securities	$ 56,277	$	$	$	$ 2,524	$ 58,801
Mortgage servicing asset	2,080		2,125	225		4,430
Total	$ 58,357	$	$ 2,125	$ 225	$ 2,524	$ 63,231
Three months ended March 31, 2012						
Available for sale securities	$ 60,377	$	$	$	$ (3,817)	$ 56,560
Total	$ 60,377	$	$	$	$ (3,817)	$ 56,560

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

All net unrealized gains (losses) in the table above are reflected in the accompanying consolidated financial statements. The unrealized gains (losses) relate to financial instruments still held at March 31, 2013. The available for sale securities noted in the tables above reflect Hilltop s note receivable and warrant with SWS Group, Inc. (SWS) as discussed in Note 4 to the consolidated financial statements.

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 an increase or decrease in the fair value measurement of the note receivable.

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 stock price would result in a significant change in the fair value measurement of the warrant.

The mortgage servicing asset is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the mortgage servicing asset is impacted by a variety of factors, including prepayment assumptions, discount rates, delinquency rates, contractually specified servicing fees, servicing costs and underlying portfolio characteristics.

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

The following table presents 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 March 31, 2013			Three Months Ended March 31, 2012		
	Net Gains from Sale of Loans	Other Noninterest Income	Total Changes in Fair Value	Net Gains from Sale of Loans	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	$ (5,438)	$	$ (5,438)	$	$	$
Other assets	2,350		2,350			
Time deposits		8	8			

Hilltop also determines the fair value of certain assets and liabilities on a non-recurring basis. 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 Hilltop reports impaired loans at fair value through specific allowances within the allowance for loan losses. Hilltop acquired impaired, or purchased credit impaired (PCI) loans with a fair value of $172.9 million at acquisition. The fair value of PCI loans was determined using Level 3 inputs, including estimates of expected cash flows that incorporated assumptions regarding default rates, loss severity rates assuming default, prepayment speeds and estimated collateral values. At March 31, 2013, PCI loans with a carrying amount of $157.0 million had been reduced by specific allowances within the allowance for loan losses of $0.4 million, resulting in a reported fair value of $156.6 million.

Other Real Estate Owned Hilltop reports other real estate owned at fair value less estimated cost to sell. Any excess of recorded investment over fair value less cost to sell is charged against the allowance for loan losses when property is initially transferred to other real estate owned. Subsequent to the initial transfer to other real estate owned, downward valuation adjustments are charged against earnings. Hilltop primarily determines fair value using Level 2 inputs consisting of independent appraisals. At March 31, 2013, the estimated fair value of other real estate owned was $7.5 million.

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 filed with the SEC on March 15, 2013.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The following tables present the carrying values and estimated fair values of financial instruments (in thousands).

March 31, 2013	Carrying Amount	Estimated Fair Value Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
Financial assets:					
Cash and short-term investments	$ 612,529	$ 612,529	$	$	$ 612,529
Securities	1,207,274	21,961	1,126,512	58,801	1,207,274
Loans held for sale	1,242,322		1,242,322		1,242,322
Loans, net	3,231,730			3,267,917	3,267,917
Broker-dealer and clearing organization receivables	187,833		187,833		187,833
Fee award receivable	18,091		18,091		18,091
Cash surrender value of life insurance policies	24,171		24,171		24,171
Interest rate swaps, interest rate lock commitments and forward purchase commitments	22,600		22,600		22,600
Mortgage servicing asset	4,430			4,430	4,430
Accrued interest receivable	17,428		17,428		17,428
Financial liabilities:					
Deposits	4,758,438		4,762,428		4,762,428
Broker-dealer and clearing organization payables	250,280		250,280		250,280
Other trading liabilities	52		52		52
Short-term borrowings	576,730		576,730		576,730
Debt	207,759		215,886		215,886
Commitments to sell mortgage-backed securities	7,481		7,481		7,481
Accrued interest payable	3,385		3,385		3,385

December 31, 2012	Carrying Amount	Estimated Fair Value Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
Financial assets:					
Cash and short-term investments	$ 726,460	$ 726,460	$	$	$ 726,460
Securities	1,081,066	20,428	1,004,361	56,277	1,081,066
Loans held for sale	1,401,507		1,401,507		1,401,507
Loans, net	3,148,987			3,148,987	3,148,987
Broker-dealer and clearing organization receivables	145,564		145,564		145,564

Fee award receivable	18,467		18,467		18,467
Cash surrender value of life insurance policies	24,086		24,086		24,086
Interest rate swaps, interest rate lock commitments and forward purchase commitments	15,697		15,697		15,697
Mortgage servicing asset	2,080			2,080	2,080
Accrued interest receivable	16,541		16,541		16,541
Financial liabilities:					
Deposits	4,700,461		4,698,848		4,698,848
Broker-dealer and clearing organization payables	187,990		187,990		187,990
Other trading liabilities	3,164		3,164		3,164
Short-term borrowings	728,250		728,250		728,250
Debt	208,551		217,092		217,092
Commitments to sell mortgage-backed securities	1,080		1,080		1,080
Accrued interest payable	4,400		4,400		4,400

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4. Securities

The amortized cost and fair value of available for sale securities are summarized as follows (in thousands).

March 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$ 7,159	$ 118	$ (3)	$ 7,274
U.S. government agencies:				
Bonds	630,725	1,527	(956)	631,296
Residential mortgage-backed securities	16,927	426	(150)	17,203
Collateralized mortgage obligations	165,520	411	(243)	165,688
Corporate debt securities	72,811	7,016		79,827
States and political subdivisions	166,057	416	(3,090)	163,383
Commercial mortgage-backed securities	991	81		1,072
Equity securities	19,423	2,537		21,960
Note receivable	41,020	3,745		44,765
Warrant	12,068	1,969		14,037
Totals	$ 1,132,701	$ 18,246	$ (4,442)	$ 1,146,505

December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$ 7,046	$ 141	$ (2)	$ 7,185
U.S. government agencies:				
Bonds	524,888	1,663	(314)	526,237
Residential mortgage-backed securities	18,473	490	(70)	18,893
Collateralized mortgage obligations	97,812	191	(79)	97,924
Corporate debt securities	79,716	7,461		87,177
States and political subdivisions	177,701	196	(2,138)	175,759
Commercial mortgage-backed securities	1,001	72		1,073
Equity securities	19,289	1,139		20,428
Note receivable	40,508	3,652		44,160
Warrant	12,068	49		12,117
Totals	$ 978,502	$ 15,054	$ (2,603)	$ 990,953

Included within the available for sale equity securities are 1,475,387 shares of SWS common stock. Furthermore, the available for sale securities include a senior unsecured loan to SWS in July 2011 in a principal amount of $50.0 million pursuant to a credit agreement, which loan 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. SWS issued Hilltop a warrant to purchase 8,695,652 shares of SWS common stock, $0.10 par value per share, exercisable at a price of $5.75 per share subject to anti-dilution adjustments. If the warrant was fully exercised, Hilltop would beneficially own 24.6% of SWS.

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Information regarding available for sale securities that were in an unrealized loss position is shown in the following table (dollars in thousands).

	March 31, 2013			December 31, 2012		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
U.S. treasury securities:						
Unrealized loss for less than twelve months	3	$ 4,482	$ 3	$ 2	$ 2,427	$ 2
Unrealized loss for twelve months or longer	1	399				
	4	4,881	3	2	2,427	2
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	21	340,047	956	14	236,305	314
Unrealized loss for twelve months or longer						
	21	340,047	956	14	236,305	314
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	3	9,900	150	7	12,279	70
Unrealized loss for twelve months or longer						
	3	9,900	150	7	12,279	70
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	9	83,102	243	8	38,887	79
Unrealized loss for twelve months or longer						
	9	83,102	243	8	38,887	79
States and political subdivisions:						
Unrealized loss for less than twelve months	199	131,527	3,090	225	156,664	2,138
Unrealized loss for twelve months or longer						
	199	131,527	3,090	225	156,664	2,138
Total available for sale:						
Unrealized loss for less than twelve months	235	569,058	4,442	256	446,562	2,603
Unrealized loss for twelve months or longer	1	399				
	236	$ 569,457	$ 4,442	256	$ 446,562	$ 2,603

During the three months ended March 31, 2013 and 2012, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, our analysis and experience indicate that these investments generally do not present a great 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 March 31, 2013.

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Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The amortized cost and fair value of securities, excluding trading and available for sale equity securities, at March 31, 2013, are shown by contractual maturity below (in thousands).

	Amortized Cost	Fair Value
Due in one year or less	$ 25,874	$ 26,150
Due after one year through five years	82,885	87,836
Due after five years through ten years	45,284	48,011
Due after ten years	722,709	719,783
	876,752	881,780
Residential mortgage-backed securities	16,927	17,203
Collateralized mortgage obligations	165,520	165,688
Commercial mortgage-backed securities	991	1,072
	$ 1,060,190	$ 1,065,743

FSC realized a net loss from its trading securities portfolio of $1.0 million during the three months ended March 31, 2013, which is recorded as a component of other noninterest income within the consolidated statement of operations.

Securities with a carrying amount of $783.0 million and $635.2 million (with a fair value of $786.7 million and $633.4 million) at March 31, 2013 and December 31, 2012, respectively, 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.

At both March 31, 2013 and December 31, 2012, NLASCO had investments on deposit in custody for various state insurance departments with carrying values of $9.3 million.

5. Loans and Allowance for Loan Losses

Loans summarized by category are as follows (in thousands).

	March 31,	December 31,

	2013	2012
Commercial and industrial	$ 1,705,208	$ 1,660,293
Real estate	1,237,352	1,184,914
Construction and land development	279,374	280,483
Consumer	26,433	26,706
	3,248,367	3,152,396
Allowance for loan losses	(16,637)	(3,409)
Total loans, net of allowance	$ 3,231,730	$ 3,148,987

PlainsCapital 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 regulatory guidelines. 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.

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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 global 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 global cash flow analysis based on the significance the guarantors are expected to serve as secondary repayment sources. PlainsCapital 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.

PlainsCapital 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 Merger, Hilltop acquired loans both with and without evidence of credit quality deterioration since origination. The acquired loans were initially recorded at fair value with no carryover of any allowance for loan losses. The following table presents the outstanding contractual balance and the carrying value of the PCI loans at March 31, 2013 and December 31, 2012 (in thousands).

	March 31, 2013	December 31, 2012
Carrying amount	$ 157,024	$ 166,780
Outstanding balance	210,416	222,674

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

	Three Months Ended March 31, 2013
Balance, beginning of period	$ 17,553
Increases in expected cash flows	11,996
Disposals of loans	(26)
Accretion	(3,277)
Balance, end of period	$ 26,246

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. Impaired loans include non-accrual loans, troubled debt restructurings (TDRs), PCI loans and partially charged-off loans.

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Impaired loans are summarized by class in the following tables (in thousands). There were no impaired loans at December 31, 2012, other than PCI loans, and therefore no related allowance.

March 31, 2013	Unpaid Contractual Principal Balance	Nonaccretable Difference	Accretable Yield	Total Recorded Investment	Related Allowance
Commercial and industrial:					
Secured	$ 91,154	$ 23,380	$ 7,264	$ 68,666	$ 228
Unsecured	11,664	6,355	5,649	2,794	
Real estate:					
Secured by commercial properties	61,850	13,259	8,031	51,223	156
Secured by residential properties	10,180	1,853	892	8,098	18
Construction and land development:					
Residential construction loans	29	5	24		
Commercial construction loans and land development	35,452	7,256	4,377	26,171	29
Consumer	87	14	9	72	
	$ 210,416	$ 52,122	$ 26,246	$ 157,024	$ 431

December 31, 2012	Unpaid Contractual Principal Balance	Nonaccretable Difference	Accretable Yield	Total Recorded Investment
Commercial and industrial:				
Secured	$ 91,633	$ 24,982	$ 6,114	$ 67,967
Unsecured	12,198	8,707	472	3,419
Real estate:				
Secured by commercial properties	66,736	15,816	7,294	55,519
Secured by residential properties	8,690	2,251	557	6,728
Construction and land development:				
Residential construction loans	995	493	40	708
Commercial construction loans and land development	42,330	9,113	3,067	32,362
Consumer	92	16	9	77
	$ 222,674	$ 61,378	$ 17,553	$ 166,780

Average investment in impaired loans for the three months ended March 31, 2013 is summarized by class in the following table (in thousands).

Commercial and industrial:	
Secured	$ 68,316
Unsecured	3,107

Real estate:		
Secured by commercial properties		53,371
Secured by residential properties		7,413
Construction and land development:		
Residential construction loans		354
Commercial construction loans and land development		29,266
Consumer		75
	$	161,902

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Interest income recorded on non-accrual loans for the three months ended March 31, 2013 was nominal.

Non-accrual loans at March 31, 2013 were $3.4 million, primarily composed of real estate loans secured by residential properties that are classified as held for sale and carried at fair value, as well as lease financing receivables. At December 31, 2012, non-accrual loans were $1.8 million, all of which were real estate loans secured by residential properties that are classified as held for sale and carried at fair value. All PCI loans are considered to be performing due to the application of the accretion method.

PlainsCapital 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. PlainsCapital modifies loans by reducing interest rates and/or lengthening loan amortization schedules. PlainsCapital 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 for the three months ended March 31, 2013 is shown in the following table (in thousands). All TDRs granted relate to PCI loans. At March 31, 2013, PlainsCapital had no unadvanced commitments to borrowers whose loans have been restructured in troubled debt restructurings.

	Recorded Investment in Loans Modifed by			
	A/B Note	Interest Rate Adjustment	Payment Term Extension	Total Modification
Commercial and industrial:				
Secured	$	$	$ 28	$ 28
Unsecured				
Real estate:				
Secured by commercial properties			1,236	1,236
Secured by residential properties			262	262
Construction and land development:				
Residential construction loans				
Commercial construction loans and land development			570	570
Consumer				
	$	$	$ 2,096	$ 2,096

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An analysis of the aging of PlainsCapital s loan portfolio is shown in the following tables (in thousands). PCI loans are considered to be performing due to the application of the accretion method.

March 31, 2013	Loans Past Due 30-89 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	$ 6,150	$ 1,510	$ 7,660	$ 1,512,663	$ 68,666	$ 1,588,989	$
Unsecured	259		259	113,166	2,794	116,219	
Real estate:							
Secured by commercial properties	796		796	912,690	51,223	964,709	
Secured by residential properties	1,257	108	1,365	263,180	8,098	272,643	
Construction and land development:							
Residential construction loans				43,174		43,174	
Commercial construction loans and land development	178		178	209,851	26,171	236,200	
Consumer	20		20	26,341	72	26,433	
	$ 8,660	$ 1,618	$ 10,278	$ 3,081,065	$ 157,024	$ 3,248,367	$

December 31, 2012	Loans Past Due 30-89 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	$ 8,192	$ 2,131	$ 10,323	$ 1,473,242	$ 67,967	$ 1,551,532	$ 2,000
Unsecured	3		3	105,339	3,419	108,761	
Real estate:							
Secured by commercial properties	714		714	868,070	55,519	924,303	
Secured by residential properties	856		856	253,027	6,728	260,611	
Construction and land development:							
Residential construction loans	63		63	47,398	708	48,169	
Commercial construction loans and land development				199,952	32,362	232,314	
Consumer	84		84	26,545	77	26,706	
	$ 9,912	$ 2,131	$ 12,043	$ 2,973,573	$ 166,780	$ 3,152,396	$ 2,000

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.

PlainsCapital 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 A Special Mention asset has 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 asset and weaken the Bank s credit position at some future date. Special Mention assets 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 loans, as previously described, in the portfolio by class (in thousands).

March 31, 2013	Pass	Special Mention	Substandard	PCI	Total
Commercial and industrial:					
Secured	$ 1,510,466	$ 2,759	$ 7,098	$ 68,666	$ 1,588,989
Unsecured	113,223	81	121	2,794	116,219
Real estate:					
Secured by commercial properties	913,486			51,223	964,709
Secured by residential properties	264,437		108	8,098	272,643
Construction and land development:					
Residential construction loans	43,174				43,174
Commercial construction loans and land development	209,581		448	26,171	236,200
Consumer	26,361			72	26,433
	$ 3,080,728	$ 2,840	$ 7,775	$ 157,024	$ 3,248,367

December 31, 2012	Pass	Special Mention	Substandard	PCI	Total
Commercial and industrial:					
Secured	$ 1,476,420	$ 2,515	$ 4,630	$ 67,967	$ 1,551,532
Unsecured	105,142	200		3,419	108,761
Real estate:					
Secured by commercial properties	868,784			55,519	924,303
Secured by residential properties	253,883			6,728	260,611
Construction and land development:					
Residential construction loans	47,461			708	48,169
Commercial construction loans and land development	199,952			32,362	232,314
Consumer	26,629			77	26,706
	$ 2,978,271	$ 2,715	$ 4,630	$ 166,780	$ 3,152,396

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 our Board of Directors and the Directors 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. Any subsequent recovery of charged-off loans is added back to the allowance for loan losses. As a result of the Merger on November 30, 2012, PlainsCapital s loan portfolio is now designated into two populations, acquired and originated loans. The allowance for loan losses is calculated separately for the 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 and is 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 non-impaired loans are within the scope of the Contingencies Topic. Estimates of loss for the Contingencies Topic are calculated based on historical loss experience by

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loan portfolio segment adjusted for changes in trends, conditions, and other relevant factors that affect repayment of loans as of the evaluation date. While historical loss experience provides a reasonable starting point for the analysis, historical losses, or recent trends in losses, are not the sole basis upon which to determine 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 lending policies and procedures; changes in underwriting standards; changes in economic and business conditions and developments that affect the collectability of the portfolio; the condition of various market segments; changes in the nature and volume of the portfolio and in the terms of loans; changes in lending management and staff; changes in the volume and severity of past due loans, the volume of non-accrual loans, and the volume and severity of adversely classified or graded loans; changes in the loan review system; changes in the value of underlying collateral for collateral-dependent loans; and any concentrations of credit and changes in the level of such concentrations.

The loan review program is designed to identify and monitor problem loans by maintaining a credit grading process, ensuring that timely and appropriate changes are made to the loans with assigned risk grades and coordinating the delivery of the information necessary to assess the appropriateness of the allowance for loan losses. Loans are evaluated for impairment 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.

Homogenous 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 homogenous pool of loans based on the expected net charge-offs from current trends in delinquencies, losses or historical experience and general economic conditions. At March 31, 2013 and December 31, 2012, there were no material delinquencies in these types of loans.

Acquired Loans

Purchased 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. Performing acquired loans 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 is compared to the remaining fair value discount for that loan. 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.

For acquired impaired loans, cash flows expected to be collected are recast at each reporting date for each loan. 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 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 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.

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Changes in the allowance for loan losses for the three months ended March 31, 2013, distributed by portfolio segment, are shown below (in thousands).

	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Balance, beginning of period	$ 1,845	$ 977	$ 582	$ 5	$ 3,409
Provision charged to operations	6,911	2,437	3,597	60	13,005
Loans charged off	(438)	(31)		(56)	(525)
Recoveries on charged off loans	494	139	107	8	748
Balance, end of period	$ 8,812	$ 3,522	$ 4,286	$ 17	$ 16,637

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

March 31, 2013	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Loans individually evaluated for impairment	$ 1,507	$ 108	$	$	$ 1,615
Loans collectively evaluated for impairment	1,632,241	1,177,923	253,203	26,361	3,089,728
PCI Loans individually evaluated for impairment	71,460	59,321	26,171	72	157,024
	$ 1,705,208	$ 1,237,352	$ 279,374	$ 26,433	$ 3,248,367

December 31, 2012	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Total
Loans individually evaluated for impairment	$	$	$	$	$
Loans collectively evaluated for impairment	1,588,907	1,122,667	247,413	26,629	2,985,616
PCI Loans individually evaluated for impairment	71,386	62,247	33,070	77	166,780
	$ 1,660,293	$ 1,184,914	$ 280,483	$ 26,706	$ 3,152,396

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

March 31, 2013		Commercial and Industrial		Real Estate		Construction and Land Development		Consumer		Total
Loans individually evaluated for impairment	$		$		$		$		$	
Loans collectively evaluated for impairment		8,584		3,348		4,257		17		16,206
PCI Loans individually evaluated for impairment		228		174		29				431
	$	8,812	$	3,522	$	4,286	$	17	$	16,637

December 31, 2012		Commercial and Industrial		Real Estate		Construction and Land Development		Consumer		Total
Loans individually evaluated for impairment	$		$		$		$		$	
Loans collectively evaluated for impairment		1,845		977		582		5		3,409
PCI Loans individually evaluated for impairment										
	$	1,845	$	977	$	582	$	5	$	3,409

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

6. Deposits

Deposits are summarized as follows (in thousands).

	March 31, 2013	December 31, 2012
Noninterest-bearing demand	$ 249,678	$ 323,367
Interest-bearing:		
NOW accounts	138,591	106,562
Money market	2,326,046	2,357,109
Brokered - money market	264,715	263,193
Demand	54,087	75,308
Savings	185,812	180,367
Time	1,286,950	1,175,432
Brokered - time	252,559	219,123
	$ 4,758,438	$ 4,700,461

7. Short-term Borrowings

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

	March 31, 2013	December 31, 2012
Federal funds purchased	$ 301,775	$ 269,625
Securities sold under agreements to repurchase	113,955	85,725
Federal Home Loan Bank (FHLB) notes		250,000
Short-term bank loans	161,000	122,900
	$ 576,730	$ 728,250

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).

	Three Months Ended March 31, 2013
Average balance during the period	$ 328,521
Average interest rate during the period	0.21%

	March 31, 2013	December 31, 2012
Average interest rate at end of period	0.18%	0.22%
Securities underlying the agreements at end of period		
Carrying value	$ 139,817	$ 122,153
Estimated fair value	$ 139,890	$ 122,435

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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).

	Three Months Ended March 31, 2013
Average balance during the period	$ 34,174
Average interest rate during the period	0.09%

	March 31, 2013	December 31, 2012
Average interest rate at end of period		0.07%

FSC uses short-term bank loans periodically to finance securities owned, customers margin accounts and underwriting activities. Interest on the borrowings varies with the federal funds rate. The weighted average interest rate on the borrowings at March 31, 2013 and December 31, 2012 was 1.15% and 1.16%, respectively.

8. Income Taxes

Hilltop 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 36.5% and 37.2% for the three months ended March 31, 2013 and 2012, 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 March 31, 2013 and 2012. The Company does not anticipate any significant liabilities for uncertain tax positions to arise in the next twelve months.

Hilltop files income tax returns in U.S. federal and several U.S. state jurisdictions. The Company is subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitations expires. Excluding those entities acquired as a part of the PlainsCapital Merger, Hilltop has been examined by U.S. tax authorities for U.S. federal income tax years prior to 2010, and is under no federal or state tax audits at March 31, 2013. PlainsCapital has been examined by U.S. tax authorities for U.S. federal income tax years prior to 2010, and is under no federal or state tax audits at March 31, 2013.

9. Commitments and Contingencies

Legal Matters

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

Hilltop and its subsidiaries are defendants in various legal matters arising in the normal course of business. Management believes that the ultimate liability, if any, arising from these matters will not materially affect our consolidated financial condition, results of operations or cash flows taken as a whole.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

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Other Contingencies

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 (a make-whole payment). The mortgage origination segment has established an indemnification liability for such probable losses based upon, among other things, the level of current unresolved repurchase requests, the volume of estimated probable future repurchase requests, our ability to cure the defects identified in the repurchase requests, and the severity of the estimated loss upon repurchase. At March 31, 2013 and December 31, 2012, the indemnification reserve totaled $19.7 million and $19.0 million, respectively. The provision for indemnification losses was $0.9 million for the three months ended March 31, 2013. Although management considers this reserve to be appropriate, there can be no assurance that the reserve will prove to be appropriate over time to cover ultimate losses, primarily 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 will be considered in the reserving process when known.

10. 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 $1.0 billion at March 31, 2013 and outstanding standby letters of credit of $35.0 million at March 31, 2013.

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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

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11. 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.

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). The Tier 1 capital (to average assets) ratio at December 31, 2012 was calculated using the average assets for the month of December 2012.

A comparison of the Bank s and Hilltop s actual capital amounts and ratios to the minimum requirements is as follows (dollars in thousands).

	March 31, 2013			
	Required		Actual	
	Amount	Ratio	Amount	Ratio
Bank:				
Tier 1 capital (to average assets)	$ 248,671	4%	$ 572,965	9.22%
Tier 1 capital (to risk-weighted assets)	187,655	4%	572,965	