

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**  
(State or other jurisdiction of incorporation or organization)

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

**200 Crescent Court, Suite 1330**  
**Dallas, TX**

**75201**

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(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  No

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

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

|                         |  |                           |                          |
|-------------------------|--|---------------------------|--------------------------|
| Large accelerated filer | <input checked="" type="checkbox"/>                                    | Accelerated filer         | <input type="checkbox"/> |
| Non-accelerated filer   | <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company | <input type="checkbox"/> |

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

The number of shares of the registrant's common stock outstanding at 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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(in thousands, except share and per share data)

|   | June 30,<br>2014<br>(Unaudited) | December 31,<br>2013 |
|---|---------------------------------|----------------------|
| <b>Assets</b>   |                                 |                      |
| 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         |
| <b>Liabilities and Stockholders' Equity</b>   |                                 |                      |
| 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              |

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|  |    |           |              |
|--|----|-----------|--------------|
| 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, |                | Six Months Ended June 30, |                |
|--|-----------------------------|----------------|---------------------------|----------------|
|  | 2014                        | 2013           | 2014                      | 2013           |
| <b>Interest income:</b>  |                             |                |                           |                |
| Loans, including fees  | \$ 92,204                   | \$ 65,213      | \$ 171,948                | \$ 130,099     |
| <b>Securities:</b>   |                             |                |                           |                |
| 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          |
| <b>Total interest income</b>   | <b>104,408</b>              | <b>76,168</b>  | <b>196,236</b>            | <b>150,772</b> |
| <b>Interest expense:</b>   |                             |                |                           |                |
| 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          |
| <b>Total interest expense</b>  | <b>5,962</b>                | <b>7,743</b>   | <b>12,369</b>             | <b>15,086</b>  |
| <b>Net interest income</b>   | <b>98,446</b>               | <b>68,425</b>  | <b>183,867</b>            | <b>135,686</b> |
| Provision for loan losses  | 5,533                       | 11,289         | 8,775                     | 24,294         |
| <b>Net interest income after provision for loan losses</b>             | <b>92,913</b>               | <b>57,136</b>  | <b>175,092</b>            | <b>111,392</b> |
| <b>Noninterest income:</b>   |                             |                |                           |                |
| 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         |
| <b>Total noninterest income</b>  | <b>203,281</b>              | <b>239,233</b> | <b>373,381</b>            | <b>452,511</b> |
| <b>Noninterest expense:</b>  |                             |                |                           |                |
| 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         |
| <b>Total noninterest expense</b>                                       | <b>251,212</b>              | <b>260,400</b> | <b>463,841</b>            | <b>475,391</b> |
| <b>Income before income taxes</b>                                      | <b>44,982</b>               | <b>35,969</b>  | <b>84,632</b>             | <b>88,512</b>  |
| Income tax expense   | 16,294                      | 13,309         | 30,648                    | 32,479         |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| 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.*

Table of Contents**HILLTOP HOLDINGS INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(in thousands)****(Unaudited)**

|  | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|--|------------------------------------|-------------|----------------------------------|-------------|
|  | <b>2014</b>                        | <b>2013</b> | <b>2014</b>                      | <b>2013</b> |
| 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 |            | Common Stock |        | Additional   | Accumulated   | Accumulated  | Total        | Noncontrolling | Total        |
|---|-----------------|------------|--------------|--------|--------------|---------------|--------------|--------------|----------------|--------------|
|   | Shares          | Amount     | Shares       | Amount | Paid-in      | Other         | Deficit      | Stockholders | Interest       | Stockholders |
|   |                 |            |              |        | Capital      | Income (Loss) |              | Equity       |                | 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                      | 2013        |
| <b>Operating Activities</b>   |                           |             |
| 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      |
| <b>Investing Activities</b>   |                           |             |
| 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)   |
| <b>Financing Activities</b>   |                           |             |
| 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     |

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|  |    |         |    |         |
|--|----|---------|----|---------|
| Cash and cash equivalents, end of period                 | \$ | 688,785 | \$ | 626,053 |
| <b>Supplemental Disclosures of Cash Flow Information</b> |    |         |    |         |
| Cash paid for interest                                   | \$ | 13,046  | \$ | 14,889  |
| Cash paid for income taxes, net of refunds               | \$ | 5,582   | \$ | 40,949  |
| <b>Supplemental Schedule of Non-Cash Activities</b>      |    |         |    |         |
| 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 ).

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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.

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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



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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<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair Value |
|---------------------------------|-------------------|-------------------|-------------------|---------------------|
| <b>June 30, 2014</b>            |                   |                   |                   |                     |
| 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<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair Value |
|--|-------------------|-------------------|-------------------|---------------------|
|--|-------------------|-------------------|-------------------|---------------------|

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**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<br>Beginning of<br>Period | Purchases/<br>Additions | Sales/<br>Reductions | Included in<br>Net Income | Total Gains or Losses<br>(Realized or Unrealized)<br>Included in Other<br>Comprehensive<br>Income (Loss) | Balance at<br>End of Period |
|------------------------------------|--------------------------------------|-------------------------|----------------------|---------------------------|--|-----------------------------|
| <b>Three months ended</b>          |                                      |                         |                      |                           |  |                             |
| <b>June 30, 2014</b>               |                                      |                         |                      |                           |  |                             |
| 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<br>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                  |
| <b>Six months ended June 30,</b>   |                                      |                         |                      |                           |  |                             |
| <b>2014</b>                        |                                      |                         |                      |                           |  |                             |
| 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<br>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                  |
| <b>Three months ended</b>          |                                      |                         |                      |                           |  |                             |
| <b>June 30, 2013</b>               |                                      |                         |                      |                           |  |                             |
| Available for sale securities      | \$ 58,801                            | \$                      | \$                   | \$ 531                    | \$ (3,822)   | \$ 55,510                   |
| Mortgage servicing rights<br>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                   |
| <b>Six months ended June 30,</b>   |                                      |                         |                      |                           |  |                             |
| <b>2013</b>                        |                                      |                         |                      |                           |  |                             |
| Available for sale securities      | \$ 56,277                            | \$                      | \$                   | \$ 1,043                  | \$ (1,810)   | \$ 55,510                   |
| Mortgage servicing rights<br>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.

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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<br>Discount rate                   | 10.32%<br>11.11%               |
| Derivative liabilities                          | Discounted cash flow                     | Discount rate<br>Time to receive full payment of cash flows | 14 - 28%<br>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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|                          | Net<br>Gains (Losses) | Other<br>Noninterest<br>Income | Total<br>Changes in<br>Fair Value | Net<br>Gains (Losses) | Other<br>Noninterest<br>Income | Total<br>Changes in<br>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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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(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<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair Value | Total Gains (Losses) for the<br>Three Months Ended June 30, |          | Total Gains (Losses) for the<br>Six Months Ended June 30, |          |
|-------------------------------------|-------------------|-------------------|-------------------|---------------------|---|----------|---|----------|
|                                     |                   |                   |                   |                     | 2014  | 2013     | 2014  | 2013     |
| <b>June 30, 2014</b>                |                   |                   |                   |                     |   |          |   |          |
| 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



December 31, 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 not measured at fair value on either a recurring or non-recurring basis (in thousands).

|  | Carrying<br>Amount | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total      |
|--|--------------------|-------------------|-------------------|-------------------|------------|
| <b>June 30, 2014</b>                                   |                    |                   |                   |                   |            |
| 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<br>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<br>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      |

|  | Carrying<br>Amount | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total      |
|--|--------------------|-------------------|-------------------|-------------------|------------|
| <b>December 31, 2013</b>                               |                    |                   |                   |                   |            |
| 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<br>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<br>payables    | 129,678            |                   | 129,678           |                   | 129,678    |
| Short-term borrowings                                  | 342,087            |                   | 342,087           |                   | 342,087    |
| Debt   | 123,339            |                   | 114,671           |                   | 114,671    |

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|                   |       |       |       |
|-------------------|-------|-------|-------|
| 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).

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Available for Sale<br>Gross<br>Unrealized<br>Losses | Fair Value   |
|--|-------------------|------------------------------|---|--------------|
| <b>June 30, 2014</b>                   |                   |                              |   |              |
| 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 |

|  | Amortized<br>Cost | Unrealized<br>Gains | Available for Sale<br>Unrealized<br>Losses | Fair Value   |
|--|-------------------|---------------------|--|--------------|
| <b>December 31, 2013</b>               |                   |                     |  |              |
| 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 |

|           |                                |            |
|-----------|--------------------------------|------------|
| Amortized | Held to Maturity<br>Unrealized | Unrealized |
|-----------|--------------------------------|------------|

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|  | Cost      | Gains  | Losses  | Fair Value |
|--|-----------|--------|---------|------------|
| <b>June 30, 2014</b>                   |           |        |         |            |
| 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 |
| <b>Available for Sale</b>                   |                      |            |                   |                      |            |                   |
| 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         |

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|   | June 30, 2014        |            |                   | December 31, 2013    |            |                   |
|---|----------------------|------------|-------------------|----------------------|------------|-------------------|
|   | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses |
| <b>Held to Maturity</b>                     |                      |            |                   |                      |            |                   |
| 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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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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.



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

At 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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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

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

|   | June 30,<br>2014 | December 31,<br>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.

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

|                     | <b>June 30,</b> |        | <b>December 31,</b> |         |
|---------------------|-----------------|--------|---------------------|---------|
|                     | <b>2014</b>     |        | <b>2013</b>         |         |
| Carrying amount     | \$              | 60,787 | \$                  | 100,392 |
| Outstanding balance |                 | 83,534 |                     | 141,983 |

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

|                                  | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|----------------------------------|-----------------------------|-----------|---------------------------|-----------|
|                                  | 2014                        | 2013      | 2014                      | 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<br>Contractual<br>Principal Balance | Recorded<br>Investment with<br>No Allowance | Recorded<br>Investment with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|--|---|--|---------------------------------|----------------------|
| <b>June 30, 2014</b>                               |  |   |  |                                 |                      |
| 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             |

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|  | Unpaid<br>Contractual<br>Principal Balance | Recorded<br>Investment with<br>No Allowance | Recorded<br>Investment with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|--|---|--|---------------------------------|----------------------|
| <b>December 31, 2013</b>                           |  |   |  |                                 |                      |
| 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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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

|  | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|--|-----------------------------|------------|---------------------------|------------|
|  | 2014                        | 2013       | 2014                      | 2013       |
| <b>Commercial and industrial:</b>                  |                             |            |                           |            |
| Secured  | \$ 29,852                   | \$ 61,715  | \$ 31,631                 | \$ 61,365  |
| Unsecured  | 865                         | 2,385      | 1,022                     | 2,697      |
| <b>Real estate:</b>                                |                             |            |                           |            |
| Secured by commercial properties                   | 27,120                      | 49,687     | 30,395                    | 51,835     |
| Secured by residential properties                  | 4,541                       | 7,131      | 3,745                     | 6,446      |
| <b>Construction and land development:</b>          |                             |            |                           |            |
| 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,  | December 31, |
|--|-----------|--------------|
|  | 2014      | 2013         |
| <b>Commercial and industrial:</b>                  |           |              |
| Secured  | \$ 14,258 | \$ 15,430    |
| Unsecured  | 504       | 1,300        |
| <b>Real estate:</b>                                |           |              |
| Secured by commercial properties                   | 485       | 2,638        |
| Secured by residential properties                  | 1,887     | 398          |
| <b>Construction and land development:</b>          |           |              |
| 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.

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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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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 |



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|   | A/B Note | Recorded Investment in Loans Modified by<br>Interest Rate<br>Adjustment | Payment Term<br>Extension | Total<br>Modification |
|---|----------|---|---------------------------|-----------------------|
| <b>Six months ended June 30, 2013</b>                 |          |   |                           |                       |
| 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<br>development |          |   | 603                       | 603                   |
| Consumer  | \$       | \$  | \$ 11,780                 | \$ 11,780             |

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Notes to Consolidated Financial Statements (continued)

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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).

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

|                                    | Loans Past Due |            | Loans Past Due  |                | Loans Past Due |       | Total          | Current | PCI   | Total     | Accruing Loans           |        |  |           |  |     |
|------------------------------------|----------------|------------|-----------------|----------------|----------------|-------|----------------|---------|-------|-----------|--------------------------|--------|--|-----------|--|-----|
|                                    | 30-59 Days     | 60-89 Days | 90 Days or More | Past Due Loans | Loans          | Loans | Past Due Loans | Loans   | Loans | Loans     | Past Due 90 Days or More |        |  |           |  |     |
| <b>December 31, 2013</b>           |                |            |                 |                |                |       |                |         |       |           |                          |        |  |           |  |     |
| Commercial and industrial:         |                |            |                 |                |                |       |                |         |       |           |                          |        |  |           |  |     |
| Secured                            | \$             | 2,171      | \$              | 277            | \$             | 1,354 | \$             | 3,802   | \$    | 1,492,793 | \$                       | 272    |  |           |  |     |
| Unsecured                          |                | 333        |                 | 9              |                | 60    |                | 402     |       | 103,453   |                          | 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    |  |     |

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|  |          |          |          |          |              |            |                     |
|--|----------|----------|----------|----------|--------------|------------|---------------------|
| 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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Notes to Consolidated Financial Statements (continued)

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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        |
|--|--------------|-----------------|-------------|-----------|--------------|
| <b>June 30, 2014</b>                               |              |                 |             |           |              |
| 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        |
|--|--------------|-----------------|-------------|------------|--------------|
| <b>December 31, 2013</b>                           |              |                 |             |            |              |
| 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

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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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Notes to Consolidated Financial Statements (continued)

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

(Unaudited)

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<br>Industrial | Real Estate | Construction and<br>Land Development | Consumer | Total     |
|--|------------------------------|-------------|--------------------------------------|----------|-----------|
| <b><u>Three months ended June 30, 2014</u></b> |                              |             |                                      |          |           |
| 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<br>Industrial | Real Estate | Construction and<br>Land Development | Consumer | Total     |
|--|------------------------------|-------------|--------------------------------------|----------|-----------|
| <b><u>Six months ended June 30, 2014</u></b> |                              |             |                                      |          |           |
| 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<br>Industrial | Real Estate | Construction and<br>Land Development | Consumer | Total     |
|--|------------------------------|-------------|--------------------------------------|----------|-----------|
| <b><u>Three months ended June 30, 2013</u></b> |                              |             |                                      |          |           |
| 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    |



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

|  |    | Commercial and<br>Industrial |    | Real Estate |    | Construction and<br>Land Development |    | Consumer |    | Total   |
|--|----|------------------------------|----|-------------|----|--------------------------------------|----|----------|----|---------|
| <b><u>Six months ended June 30, 2013</u></b> |    |                              |    |             |    |                                      |    |          |    |         |
| 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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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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        |
|---|---------------------------|--------------|-----------------------------------|-----------|--------------|
| <b>June 30, 2014</b>                        |                           |              |                                   |           |              |
| 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        |
|---|---------------------------|--------------|-----------------------------------|-----------|--------------|
| <b>December 31, 2013</b>                    |                           |              |                                   |           |              |
| Loans individually evaluated for impairment | \$ 2,273                  | \$ 373       | \$ 112                            | \$        | \$ 2,758     |
| Loans collectively evaluated for impairment | 1,598,177                 | 1,417,630    | 344,622                           | 51,067    | 3,411,496    |
| PCI Loans                                   | 36,816                    | 39,250       | 19,817                            | 4,509     | 100,392      |
|   | \$ 1,637,266              | \$ 1,457,253 | \$ 364,551                        | \$ 55,576 | \$ 3,514,646 |

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

|   | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total     |
|---|---------------------------|-------------|-----------------------------------|----------|-----------|
| <b>June 30, 2014</b>                        |                           |             |                                   |          |           |
| 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  |
|---|---------------------------|-------------|-----------------------------------|----------|--------|
| <b>December 31, 2013</b>                    |                           |             |                                   |          |        |
| Loans individually evaluated for impairment | \$ 421                    | \$          | \$                                | \$       | \$ 421 |
| Loans collectively evaluated for impairment | 13,724                    | 7,953       | 7,918                             | 88       | 29,683 |
| PCI Loans                                   | 2,720                     | 378         | 39                                |          | 3,137  |

|    |        |    |       |    |       |    |    |    |        |
|----|--------|----|-------|----|-------|----|----|----|--------|
| \$ | 16,865 | \$ | 8,331 | \$ | 7,957 | \$ | 88 | \$ | 33,241 |
|----|--------|----|-------|----|-------|----|----|----|--------|

**6. Covered Assets and Indemnification Asset**

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

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

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(Unaudited)

*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).

|                                       | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---------------------------------------|--------------------------|------------------------------|
| 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).

| <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|--------------------------|------------------------------|
|--------------------------|------------------------------|

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|                     |    |         |    |           |
|---------------------|----|---------|----|-----------|
| 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).

|                                   | <b>Three Months Ended</b> |          | <b>Six Months Ended</b> |          |
|-----------------------------------|---------------------------|----------|-------------------------|----------|
|                                   | <b>June 30, 2014</b>      |          | <b>June 30, 2014</b>    |          |
| 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<br>Contractual<br>Principal Balance | Recorded<br>Investment with<br>No Allowance | Recorded<br>Investment with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|--|---|--|---------------------------------|----------------------|
| <b>June 30, 2014</b>                               |  |   |  |                                 |                      |
| 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<br>Contractual<br>Principal Balance | Recorded<br>Investment with<br>No Allowance | Recorded<br>Investment with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|--|--|---|--|---------------------------------|----------------------|
| <b>December 31, 2013</b>                           |  |   |  |                                 |                      |
| Commercial and industrial:                         |  |   |  |                                 |                      |
| Secured  | \$ 43,957                                  | \$ 28,611                                   | \$ 882                                   | \$ 28,611                       | \$ 882               |
| 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               |

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

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

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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,<br>2014 | December 31,<br>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<br>30-59 Days | Loans Past Due<br>60-89 Days | Loans Past Due<br>90 Days or More | Total<br>Past Due Loans | Current<br>Loans | PCI<br>Loans | Total<br>Loans | Accruing Loans<br>Past Due<br>90 Days or More |
|-----------------------------------|------------------------------|------------------------------|-----------------------------------|-------------------------|------------------|--------------|----------------|---|
| <b>June 30, 2014</b>              |                              |                              |                                   |                         |                  |              |                |   |
| 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  |



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|  |    |       |       |       |       |       |        |       |        |         |    |         |    |         |    |     |
|--|----|-------|-------|-------|-------|-------|--------|-------|--------|---------|----|---------|----|---------|----|-----|
| 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<br>30-59 Days | Loans Past Due<br>60-89 Days | Loans Past Due<br>90 Days or More | Total<br>Past Due Loans | Current<br>Loans | PCI<br>Loans | Total<br>Loans | Accruing Loans<br>Past Due<br>90 Days or More |    |         |    |         |    |           |
|--|------------------------------|------------------------------|-----------------------------------|-------------------------|------------------|--------------|----------------|---|----|---------|----|---------|----|-----------|
| <b>December 31, 2013</b>                           |                              |                              |                                   |                         |                  |              |                |   |    |         |    |         |    |           |
| 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                     |                  | 2,099        |                | 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      |
|--|------------|-----------------|-------------|------------|------------|
| <b>June 30, 2014</b>                               |            |                 |             |            |            |
| 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   | \$ 218,759 | \$ 1,681        | \$ 29,355   | \$ 595,218 | \$ 845,013 |

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

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

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

|   | Commercial and<br>Industrial | Real Estate | Construction and<br>Land Development | Consumer | Total    |
|---|------------------------------|-------------|--------------------------------------|----------|----------|
| <b>Three months ended June 30, 2014</b> |                              |             |                                      |          |          |
| Balance, beginning of period            | \$ 932                       | \$ 1,696    | \$ 37                                | \$       | \$ 2,665 |
| Provision charged to operations         | 214                          | 855         | 381                                  |          | 1,450    |
| Loans charged off                       |                              |             |                                      |          |          |
| Recoveries on charged off loans         |                              |             |                                      |          |          |
| Balance, end of period                  | \$ 1,146                     | \$ 2,551    | \$ 418                               | \$       | \$ 4,115 |

|                                       | Commercial and<br>Industrial | Real Estate | Construction and<br>Land Development | Consumer | Total    |
|---------------------------------------|------------------------------|-------------|--------------------------------------|----------|----------|
| <b>Six months ended June 30, 2014</b> |                              |             |                                      |          |          |
| Balance, beginning of period          | \$ 1,053                     | \$ 8        | \$                                   | \$       | \$ 1,061 |
| Provision charged to operations       | 184                          | 2,587       | 533                                  |          | 3,304    |
| Loans charged off                     | (91)                         | (44)        | (115)                                |          | (250)    |
| Recoveries on charged off loans       |                              |             |                                      |          |          |
| Balance, end of period                | \$ 1,146                     | \$ 2,551    | \$ 418                               | \$       | \$ 4,115 |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

|   | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total      |
|---|---------------------------|-------------|-----------------------------------|----------|------------|
| <b>June 30, 2014</b>                        |                           |             |                                   |          |            |
| Loans individually evaluated for impairment | \$ 915                    | \$          | \$ 801                            | \$       | \$ 1,716   |
| Loans collectively evaluated for impairment | 22,977                    | 208,870     | 16,232                            |          | 248,079    |
| PCI Loans                                   | 26,124                    | 489,355     | 79,739                            |          | 595,218    |
|   | \$ 50,016                 | \$ 698,225  | \$ 96,772                         | \$       | \$ 845,013 |

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

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

|   | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total    |
|---|---------------------------|-------------|-----------------------------------|----------|----------|
| <b>June 30, 2014</b>                        |                           |             |                                   |          |          |
| Loans individually evaluated for impairment | \$                        | \$          | \$                                | \$       | \$       |
| Loans collectively evaluated for impairment | 155                       | 10          | 36                                |          | 201      |
| PCI Loans                                   | 991                       | 2,541       | 382                               |          | 3,914    |
|   | \$ 1,146                  | \$ 2,551    | \$ 418                            | \$       | \$ 4,115 |

|   | Commercial and Industrial | Real Estate | Construction and Land Development | Consumer | Total |
|---|---------------------------|-------------|-----------------------------------|----------|-------|
| <b>December 31, 2013</b>                    |                           |             |                                   |          |       |
| Loans individually evaluated for impairment | \$                        | \$          | \$                                | \$       | \$    |
|   | 171                       | 8           |                                   |          | 179   |

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|   |    |       |    |   |    |  |          |
|---|----|-------|----|---|----|--|----------|
| Loans collectively evaluated for impairment |    |       |    |   |    |  |          |
| PCI Loans                                   |    | 882   |    |   |    |  | 882      |
|   | \$ | 1,053 | \$ | 8 | \$ |  | \$ 1,061 |

*Covered Other Real Estate Owned*

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

|                                     | <b>Three Months Ended<br/>June 30, 2014</b> |          | <b>Six Months Ended<br/>June 30, 2014</b> |          |
|-------------------------------------|---|----------|---|----------|
| Balance, beginning of period        | \$  | 152,310  | \$  | 142,833  |
| Additions to covered OREO           |   | 8,802    |   | 31,992   |
| Dispositions of covered OREO        |   | (16,410) |   | (29,692) |
| Valuation adjustments in the period |   | (2,528)  |   | (2,959)  |
| Balance, end of period              | \$  | 142,174  | \$  | 142,174  |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

*FDIC Indemnification Asset*

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

|   | <b>Three Months Ended<br/>June 30, 2014</b> |          | <b>Six Months Ended<br/>June 30, 2014</b> |          |
|---|---|----------|---|----------|
| Balance, beginning of period                        | \$  | 188,736  | \$  | 188,291  |
| FDIC Indemnification Asset accretion (amortization) |   | 490      |   | 1,847    |
| Transfers to due from FDIC and other                |   | (14,112) |   | (15,024) |
| Balance, end of period                              | \$  | 175,114  | \$  | 175,114  |

**7. Mortgage Servicing Rights**

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

|   | <b>Three Months Ended June 30,<br/>2014</b> |         | <b>June 30,<br/>2013</b> |       | <b>Six Months Ended June 30,<br/>2014</b> |        | <b>June 30,<br/>2013</b> |       |
|---|---|---------|--------------------------|-------|---|--------|--------------------------|-------|
| Balance, beginning of period                  | \$  | 29,939  | \$                       | 4,430 | \$  | 20,149 | \$                       | 2,080 |
| Additions                                     |   | 7,376   |                          | 2,180 |   | 14,808 |                          | 4,305 |
| Sales   |   |         |                          |       |   |        |                          |       |
| Changes in fair value:                        |   |         |                          |       |   |        |                          |       |
| Due to changes in model inputs or assumptions |   |         |                          |       |   |        |                          |       |
| (1)   |   | (1,113) |                          | 608   |   | 1,651  |                          | 907   |
| Due to customer payments                      |   | (325)   |                          | (107) |   | (731)  |                          | (181) |
| Balance, end of period                        | \$  | 35,877  | \$                       | 7,111 | \$  | 35,877 | \$                       | 7,111 |

|  | <b>June 30,<br/>2014</b> |           | <b>December 31,<br/>2013</b> |           |
|--|--------------------------|-----------|------------------------------|-----------|
| Mortgage loans serviced for others             | \$                       | 3,300,871 | \$                           | 1,965,883 |
| MSR as a percentage of serviced mortgage loans |                          | 1.09%     |                              | 1.02%     |

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

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

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| Weighted average constant prepayment rate | 10.32%           | 9.72%                |
| Weighted average discount rate            | 11.11%           | 12.37%               |
| Weighted average life (in years)          | 7.2              | 7.6                  |

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

|  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| Constant prepayment rate:                |                  |                      |
| Impact of 10% adverse change             | \$ (961)         | \$ (601)             |
| Impact of 20% adverse change             | (1,855)          | (1,170)              |
| Discount rate:                           |                  |                      |
| Impact of 100 basis point adverse change | (1,039)          | (631)                |
| Impact of 200 basis point adverse change | (1,994)          | (1,236)              |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

Contractually specified servicing fees, late fees and ancillary fees earned of \$2.8 million and \$0.6 million during the three months ended June 30, 2014 and 2013, respectively, and \$5.0 million and \$0.9 million during the six months ended June 30, 2014 and 2013, respectively, were included in other noninterest income within the consolidated statements of operations.

**8. Deposits**

Deposits are summarized as follows (in thousands).

|                            | June 30,<br>2014 | December 31,<br>2013 |
|----------------------------|------------------|----------------------|
| Noninterest-bearing demand | \$ 1,829,072     | \$ 1,773,749         |
| Interest-bearing:          |                  |                      |
| NOW accounts               | 1,143,753        | 1,083,596            |
| Money market               | 857,208          | 878,578              |
| Brokered - money market    | 102,228          | 276,760              |
| Demand                     | 78,133           | 47,636               |
| Savings                    | 259,540          | 357,325              |
| Time                       | 1,753,292        | 2,110,947            |
| Brokered - time            | 132,084          | 194,327              |
|                            | \$ 6,155,310     | \$ 6,722,918         |

**9. Short-term Borrowings**

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

| June 30,<br>2014 | December 31,<br>2013 |
|------------------|----------------------|
|------------------|----------------------|



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|  |    |           |    |         |
|--|----|-----------|----|---------|
| Federal funds purchased                        | \$ | 205,425   | \$ | 137,225 |
| Securities sold under agreements to repurchase |    | 129,768   |    | 107,462 |
| Federal Home Loan Bank notes                   |    | 750,000   |    |         |
| Short-term bank loans                          |    | 102,000   |    | 97,400  |
|  | \$ | 1,187,193 | \$ | 342,087 |

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.

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

|  | <b>Six Months Ended June 30,</b> |                     |
|--|----------------------------------|---------------------|
|  | <b>2014</b>                      | <b>2013</b>         |
| Average balance during the period                      | \$ 331,142                       | \$ 304,418          |
| Average interest rate during the period                | 0.17%                            | 0.20%               |
|  | <b>June 30,</b>                  | <b>December 31,</b> |
|  | <b>2014</b>                      | <b>2013</b>         |
| Average interest rate at end of period                 | 0.11%                            | 0.16%               |
| Securities underlying the agreements at end of period: |                                  |                     |
| Carrying value   | \$ 174,772                       | \$ 144,991          |
| Estimated fair value                                   | \$ 171,946                       | \$ 138,719          |

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

|   | <b>Six Months Ended June 30,</b> |                     |
|---|----------------------------------|---------------------|
|   | <b>2014</b>                      | <b>2013</b>         |
| Average balance during the period       | \$ 137,159                       | \$ 147,241          |
| Average interest rate during the period | 0.14%                            | 0.12%               |
|   | <b>June 30,</b>                  | <b>December 31,</b> |
|   | <b>2014</b>                      | <b>2013</b>         |
| Average interest rate at end of period  | 0.15%                            |                     |

FSC uses short-term bank loans periodically to finance securities owned, margin loans to customers and correspondents, and underwriting activities. Interest on the borrowings varies with the federal funds rate. The weighted average interest rate on the borrowings at June 30, 2014 and December 31, 2013 was 1.12% and 1.15%, respectively.

**10. Income Taxes**

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The Company applies an estimated annual effective rate to interim period pre-tax income to calculate the income tax provision for the quarter in accordance with the principal method prescribed by the accounting guidance established for computing income taxes in interim periods. The Company's effective rate was 36.2% and 37.0% for the three months ended June 30, 2014 and 2013, respectively, and 36.2% and 36.7% for the six months ended June 30, 2014 and 2013, respectively.

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

The Company 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, the Company 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 June 30, 2014. PlainsCapital has been examined by U.S. tax authorities for U.S. federal income tax years prior to 2011, and is under no federal or state tax audits at June 30, 2014.

For the majority of tax jurisdictions, the Company is no longer subject to federal, state or local income tax examinations by tax authorities for years prior to 2010.

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

**11. Commitments and Contingencies**

*Legal Matters*

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

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

Each of Hilltop, Peruna LLC (wholly owned subsidiary of Hilltop), SWS and the individual members of the board of directors of SWS have been named as defendants in two purported stockholder class action lawsuits arising out of the pending merger. Both lawsuits were filed in Delaware Chancery Court (*Joseph Arceri v. SWS Group, Inc. et al* and *Chaile Steinberg v. SWS Group, Inc. et al* filed April 8, 2014 and April 11, 2014, respectively). On May 13, 2014, the Delaware Chancery Court consolidated the two actions for all purposes. On June 10, 2014, plaintiffs filed a consolidated amended complaint. The complaint generally alleges, among other things, that the SWS board of directors breached its fiduciary duties to stockholders by failing to take steps to maximize stockholder value or to engage in a fair sale process before approving the merger and by making incomplete or misleading disclosures, and that the other defendants aided and abetted such breaches of fiduciary duty. The complaints allege, among other things, that the SWS board of directors labored under conflicts of interest, and that certain provisions of the merger agreement unduly restrict SWS's ability to negotiate with other potential bidders. The complaints seek relief that includes, among other things, an injunction prohibiting the consummation of the merger, rescission to the extent the merger terms have already been implemented, damages for the alleged breaches of fiduciary duty, and the payment of plaintiffs' attorneys' fees and costs. On June 16, 2014, plaintiffs moved for a preliminary injunction prohibiting the consummation of the merger, and for expedited proceedings in connection therewith. Hilltop believes that the claims are without merit and intends to vigorously defend against these actions.

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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

additional expenses and collateral costs, including reputational damage.

As a part of an industry-wide inquiry, PrimeLending received a subpoena from the Office of Inspector General of the U.S. Department of Housing and Urban Development regarding mortgage-related practices, including those relating to origination practices for loans insured by the Federal Housing Administration. PrimeLending is cooperating with this Inquiry.

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

*Other Contingencies*

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

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

An additional reserve has been established for probable investor losses that may have been incurred, but not yet reported to the mortgage origination segment based upon a reasonable estimate of such losses. Factors considered in the calculation of this reserve include, but are not limited to, the total volume of loans sold exclusive of specific investor requests, actual investor claim settlements and the severity of estimated losses resulting from future claims, and the mortgage origination segment's history of successfully curing defects identified in investor claim requests. While the mortgage origination segment's sales contracts typically include borrower early payment default repurchase provisions, these provisions have not been a primary driver of investor claims to date, and therefore, are not a primary factor considered in the calculation of this reserve.

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At June 30, 2014 and December 31, 2013, the mortgage origination segment's indemnification liability reserve totaled \$19.7 million and \$21.1 million, respectively. The provision for indemnification losses was \$0.9 million and \$1.0 million during the three months ended June 30, 2014 and 2013, respectively, and \$1.4 million and \$2.0 million during the six months ended June 30, 2014 and 2013, respectively.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

|                                 | Representation and Warranty Specific Claims<br>Activity - Origination Loan Balance<br>Three Months Ended June 30, |         |      |         | Representation and Warranty Specific Claims<br>Activity - Origination Loan Balance<br>Six Months Ended June 30, |         |      |         |
|---------------------------------|---|---------|------|---------|---|---------|------|---------|
|                                 | 2014  |         | 2013 |         | 2014  |         | 2013 |         |
| Balance, beginning of period    | \$  | 51,929  | \$   | 41,230  | \$  | 51,912  | \$   | 39,693  |
| Claims made                     |   | 11,799  |      | 8,034   |   | 17,873  |      | 19,654  |
| Claims resolved with no payment |   | (4,873) |      | (593)   |   | (9,331) |      | (8,413) |
| Repurchases                     |   | (4,360) |      | (1,248) |   | (5,268) |      | (2,899) |
| Indemnification payments        |   | (1,372) |      | (1,333) |   | (2,063) |      | (1,945) |
| Balance, end of period          | \$  | 53,123  | \$   | 46,090  | \$  | 53,123  | \$   | 46,090  |

|                              | Indemnification Liability Reserve Activity<br>Three Months Ended June 30, |        |      |        | Indemnification Liability Reserve Activity<br>Six Months Ended June 30, |         |      |        |
|------------------------------|---|--------|------|--------|---|---------|------|--------|
|                              | 2014  |        | 2013 |        | 2014  |         | 2013 |        |
| Balance, beginning of period | \$  | 20,975 | \$   | 19,701 | \$  | 21,121  | \$   | 18,964 |
| Additions for new sales      |   | 852    |      | 956    |   | 1,412   |      | 1,956  |
| Repurchases                  |   | (524)  |      | (82)   |   | (1,028) |      | (135)  |
| Early payment defaults       |   | (56)   |      | (137)  |   | (77)    |      | (232)  |
| Indemnification payments     |   | (931)  |      | (219)  |   | (1,112) |      | (524)  |
| Change in estimate           |   | (628)  |      | 178    |   | (628)   |      | 368    |
| Balance, end of period       | \$  | 19,688 | \$   | 20,397 | \$  | 19,688  | \$   | 20,397 |

Reserve for Indemnification

Liability:

|                                  |    |        |
|----------------------------------|----|--------|
| Specific claims                  | \$ | 12,761 |
| Incurred but not reported claims |    | 6,927  |
| Total                            | \$ | 19,688 |

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

In connection with the FNB Transaction, the Bank entered into two loss-share agreements with the FDIC that collectively cover \$1.2 billion of loans and OREO acquired in the FNB Transaction. Pursuant to the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets: (i) 80% of losses on the first \$240.4 million of losses incurred; (ii) 0% of losses in excess of \$240.4 million up to and including \$365.7 million of losses incurred; and (iii) 80% of losses in excess of \$365.7 million of losses incurred. The Bank has also agreed to reimburse the FDIC for any subsequent recoveries. The loss-share agreements for commercial and single family



residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC's initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement.

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

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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 \$1.2 billion at June 30, 2014 and outstanding financial and performance standby letters of credit of \$40.6 million at June 30, 2014.

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

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

### **13. Stock-Based Compensation**

Pursuant to the Hilltop Holdings 2012 Equity Incentive Plan (the 2012 Plan), the Company may grant nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, dividend equivalent rights and other awards to employees of the Company, its subsidiaries and outside directors of the Company. Upon the approval by stockholders and effectiveness of the 2012 Plan in September 2012, no additional awards were permissible under the 2003 Equity Incentive Plan (the 2003 Plan). In the aggregate, 4,000,000 shares of common stock may be delivered pursuant to awards granted under the 2012 Plan. At June 30, 2014, 3,167,928 shares of common stock remain available for issuance pursuant to the 2012 Plan.

During the six months ended June 30, 2014, the Compensation Committee of the Board of Directors of the Company awarded certain executives and key employees an aggregate of 346,718 restricted stock units (RSUs) pursuant to the 2012 Plan. A total of 276,681 of these RSUs are subject to time-based vesting conditions and generally cliff vest on the third anniversary of the grant date, and the remaining RSUs vest based upon the achievement of certain performance goals over a three-year period. These RSUs are subject to service conditions set forth in the award

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agreements, with associated costs recognized on a straight-line basis over the respective vesting periods. The weighted average grant date fair value related to these RSUs was \$23.92 per share. At June 30, 2014, unrecognized compensation expense related to these RSUs was \$7.7 million, which will be amortized through March 2017. The RSUs are not transferable, and the shares of common stock issuable upon conversion of vested RSUs are generally subject to transfer restrictions for a period of one year following conversion, subject to certain exceptions. In addition, the applicable RSU award agreements provide for accelerated vesting under certain conditions.

During 2013, the Compensation Committee of the Board of Directors of the Company awarded certain executives and key employees a total of 471,000 restricted shares of common stock ( Restricted Stock Awards ) pursuant to the 2012 Plan. These Restricted Stock Awards generally cliff vest on the third anniversary of the grant date and are subject to service conditions set forth in the award agreements, with associated costs recognized on a straight-line basis over the respective vesting periods. The weighted average grant date fair value related to these Restricted Stock Awards was \$13.32 per share. At June 30, 2014, unrecognized compensation expense related to these Restricted Stock Awards was \$3.8 million, which will be amortized through September 2016. The award agreements governing these Restricted Stock Awards provide for accelerated vesting under certain conditions.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

During the six months ended June 30, 2014 and 2013, Hilltop granted 5,011 and 3,530 shares of common stock to independent members of the Company's Board of Directors for services rendered to the Company pursuant to the 2012 Plan.

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

Compensation expense related to the plans was \$1.3 million and \$0.4 million for the three months ended June 30, 2014 and 2013, respectively, and \$2.0 million and \$0.5 million for the six months ended June 30, 2014 and 2013, respectively.

**14. Regulatory Matters**

*Bank*

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

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

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

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

Management believes that, as of June 30, 2014, Hilltop and the Bank would meet all applicable capital adequacy requirements under the Basel III capital rules for banks with less than \$15 billion in assets on a fully phased-in basis as if such requirements were currently in effect.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

|   | Actual     |        | Minimum Capital Requirements |       | To Be Well Capitalized Minimum Capital Requirements |       |
|---|------------|--------|------------------------------|-------|---|-------|
|   | Amount     | Ratio  | Amount                       | Ratio | Amount  | Ratio |
| <b>June 30, 2014</b>                      |            |        |                              |       |   |       |
| Tier 1 capital (to average assets):       |            |        |                              |       |   |       |
| Bank                                      | \$ 811,068 | 9.97%  | \$ 325,381                   | 4%    | \$ 406,726  | 5%    |
| Hilltop                                   | 1,167,323  | 13.51% | 345,651                      | 4%    | N/A   | N/A   |
| Tier 1 capital (to risk-weighted assets): |            |        |                              |       |   |       |
| Bank                                      | 811,068    | 13.22% | 245,444                      | 4%    | \$ 368,166  | 6%    |
| Hilltop                                   | 1,167,323  | 18.11% | 257,816                      | 4%    | N/A   | N/A   |
| Total capital (to risk-weighted assets):  |            |        |                              |       |   |       |
| Bank                                      | 852,846    | 13.90% | 490,888                      | 8%    | \$ 613,610  | 10%   |
| Hilltop                                   | 1,211,017  | 18.79% | 515,632                      | 8%    | N/A   | N/A   |
| <b>December 31, 2013</b>                  |            |        |                              |       |   |       |
| Tier 1 capital (to average assets):       |            |        |                              |       |   |       |
| Bank                                      | \$ 762,364 | 9.29%  | \$ 328,275                   | 4%    | \$ 410,344  | 5%    |
| Hilltop                                   | 1,112,424  | 12.81% | 347,480                      | 4%    | N/A   | N/A   |
| Tier 1 capital (to risk-weighted assets): |            |        |                              |       |   |       |
| Bank                                      | 762,364    | 13.38% | 227,984                      | 4%    | 341,976   | 6%    |
| Hilltop                                   | 1,112,424  | 18.53% | 240,159                      | 4%    | N/A   | N/A   |
| Total capital (to risk-weighted assets):  |            |        |                              |       |   |       |
| Bank                                      | 797,771    | 14.00% | 455,968                      | 8%    | 569,960   | 10%   |
| Hilltop                                   | 1,148,736  | 19.13% | 480,318                      | 8%    | N/A   | N/A   |

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

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Pursuant to the net capital requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act ), FSC has elected to determine its net capital requirements using the alternative method. Accordingly, FSC is required to maintain minimum net capital, as defined in Rule 15c3-1 promulgated under the Exchange Act, equal to the greater of \$250,000 or 2% of aggregate debit balances, as defined in Rule 15c3-3 promulgated under the Exchange Act. At June 30, 2014, FSC had net capital of \$60.3 million (the minimum net capital requirement was \$5.8 million), net capital maintained by FSC was 21% of aggregate debits, and net capital in excess of the minimum requirement was \$54.5 million.

Under certain conditions, FSC may be required to segregate cash and securities in a special reserve account for the benefit of customers under Rule 15c3-3 promulgated under the Exchange Act. Assets segregated under the provisions of the Exchange Act are not available for general corporate purposes. FSC was required to segregate \$4.0 million in cash and securities at June 30, 2014, which is included in other assets within the consolidated balance sheet. At December 31, 2013, FSC was not required to segregate cash and securities.

FSC was not required to segregate cash or securities in a special reserve account for the benefit of proprietary accounts of introducing broker-dealers at June 30, 2014 and December 31, 2013.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

*Mortgage Origination*

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

*Insurance*

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

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

|                                   | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|-----------------------------------|--------------------------|------------------------------|
| <b>Capital and surplus:</b>       |                          |                              |
| National Lloyds Insurance Company | \$ 100,479               | \$ 98,602                    |
| American Summit Insurance Company | 28,004                   | 26,452                       |

|                                     | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|-------------------------------------|------------------------------------|-------------|----------------------------------|-------------|
|                                     | <b>2014</b>                        | <b>2013</b> | <b>2014</b>                      | <b>2013</b> |
| <b>Statutory net income (loss):</b> |                                    |             |                                  |             |
| National Lloyds Insurance Company   | \$ (4,664)                         | \$ (13,331) | \$ 1,322                         | \$ (9,940)  |
| American Summit Insurance Company   | 245                                | (1,380)     | 1,376                            | (1,129)     |

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At June 30, 2014, the Company s insurance subsidiaries had statutory surplus in excess of the minimum required.



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

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

**15. Derivative Financial Instruments**

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

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

As discussed in Note 3 to the consolidated financial statements, the Company has elected to measure substantially all mortgage loans held for sale at fair value under the provisions of the Fair Value Option. The election provides the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without applying complex hedge accounting provisions. The fair values of PrimeLending's IRLCs and forward commitments are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of these derivative instruments produced a net loss of \$3.6 million for the three months ended June 30, 2014, as compared to a net gain of \$32.0 million during the same period in 2013, and a net loss of \$5.2 million for the six months ended June 30, 2014, as compared to a net gain of \$34.0 million during the same period in 2013. The changes in the fair values of these derivative instruments were recorded as a component of net gains from sale of loans and other mortgage production income. Changes in fair value are attributable to changes in the volume of IRLCs, mortgage loans held for sale, commitments to purchase and sell MBSs and changes in market interest rates. Changes in market interest rates also conversely affect the value of PrimeLending's mortgage loans held for sale, which are measured at fair value under the Fair Value Option. The effect of the change in market interest rates on PrimeLending's loans held for sale is discussed in Note 3 to the consolidated financial statements. The fair values of FSC's derivative instruments are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of FSC's derivatives produced net gains of \$3.2 million and \$3.8 million for the three months ended June 30, 2014 and 2013, respectively, and net gains of \$6.1 million and \$5.6 million for the six months ended June 30, 2014 and 2013, respectively, which were recorded as a component of other noninterest income.

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

|                         | June 30, 2014   |                      | December 31, 2013 |                      |
|-------------------------|-----------------|----------------------|-------------------|----------------------|
|                         | Notional Amount | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| Derivative instruments: |                 |                      |                   |                      |
| IRLCs                   | \$ 981,330      | \$ 28,584            | \$ 602,467        | \$ 12,151            |

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|                              |           |          |           |         |
|------------------------------|-----------|----------|-----------|---------|
| Commitments to purchase MBSs | 416,294   | 6,870    | 236,305   | (109)   |
| Commitments to sell MBSs     | 2,303,071 | (13,847) | 1,645,332 | 11,383  |
| Fee Award Option             | 20,432    | (6,300)  | 20,432    | (5,600) |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**16. Balance Sheet Offsetting**

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

|                              | Gross Amounts of Recognized Assets | Gross Amounts Offset in the Balance Sheet | Net Amounts of Assets Presented in the Balance Sheet | Gross Amounts Not Offset in the Balance Sheet<br>Financial Instruments | Cash Collateral Pledged | Net Amount |
|------------------------------|------------------------------------|---|--|--|-------------------------|------------|
| <b>June 30, 2014</b>         |                                    |   |  |  |                         |            |
| Securities borrowed:         |                                    |   |  |  |                         |            |
| Institutional counterparties | \$ 163,682                         | \$  | \$ 163,682   | \$ (163,682)   | \$                      | \$         |
|                              | \$ 163,682                         | \$  | \$ 163,682   | \$ (163,682)   | \$                      | \$         |

|                              | Gross Amounts of Recognized Assets | Gross Amounts Offset in the Balance Sheet | Net Amounts of Assets Presented in the Balance Sheet | Gross Amounts Not Offset in the Balance Sheet<br>Financial Instruments | Cash Collateral Pledged | Net Amount |
|------------------------------|------------------------------------|---|--|--|-------------------------|------------|
| <b>December 31, 2013</b>     |                                    |   |  |  |                         |            |
| Securities borrowed:         |                                    |   |  |  |                         |            |
| Institutional counterparties | \$ 107,365                         | \$  | \$ 107,365   | \$ (107,365)   | \$                      | \$         |
| Forward MBS derivatives:     |                                    |   |  |  |                         |            |
| Institutional counterparties | 11,489                             | (76)                                      | 11,413   |  | (286)                   | 11,127     |
|                              | \$ 118,854                         | \$ (76)                                   | \$ 118,778   | \$ (107,365)   | \$ (286)                | \$ 11,127  |

|                              | Gross Amounts of Recognized Liabilities | Gross Amounts Offset in the Balance Sheet | Net Amounts of Liabilities Presented in the Balance Sheet | Gross Amounts Not Offset in the Balance Sheet<br>Financial Instruments | Cash Collateral Pledged | Net Amount |
|------------------------------|---|---|---|--|-------------------------|------------|
| <b>June 30, 2014</b>         |   |   |   |  |                         |            |
| Securities loaned:           |   |   |   |  |                         |            |
| Institutional counterparties | \$ 133,162                              | \$  | \$ 133,162  | \$ (133,162)   | \$                      | \$         |
| Repurchase agreements:       |   |   |   |  |                         |            |
| Customer counterparties      | 123,856                                 |   | 123,856   | (123,856)  |                         |            |
| Institutional counterparties | 5,912                                   |   | 5,912   | (5,912)  |                         |            |
| Forward MBS derivatives:     |   |   |   |  |                         |            |
| Institutional counterparties | 13,938                                  | (91)                                      | 13,847  |  | (7,845)                 | 6,002      |
|                              | \$ 276,868                              | \$ (91)                                   | \$ 276,777  | \$ (262,930)   | \$ (7,845)              | \$ 6,002   |

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**December 31, 2013**

Securities loaned:

|                              |    |        |    |    |        |    |          |    |    |
|------------------------------|----|--------|----|----|--------|----|----------|----|----|
| Institutional counterparties | \$ | 74,913 | \$ | \$ | 74,913 | \$ | (74,913) | \$ | \$ |
|------------------------------|----|--------|----|----|--------|----|----------|----|----|

Repurchase agreements:

|                         |  |         |  |         |  |           |  |  |  |
|-------------------------|--|---------|--|---------|--|-----------|--|--|--|
| Customer counterparties |  | 107,462 |  | 107,462 |  | (107,462) |  |  |  |
|-------------------------|--|---------|--|---------|--|-----------|--|--|--|

Forward MBS derivatives:

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

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

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

|                              | June 30,<br>2014 |    | December 31,<br>2013 |
|------------------------------|------------------|----|----------------------|
| <b>Receivables:</b>          |                  |    |                      |
| Securities borrowed          | \$ 163,682       | \$ | 107,365              |
| Securities failed to deliver | 26,974           |    | 7,160                |
| Clearing organizations       | 80               |    | 4,698                |
| Due from dealers             | 28               |    | 94                   |
|                              | \$ 190,764       | \$ | 119,317              |
| <b>Payables:</b>             |                  |    |                      |
| Securities loaned            | \$ 133,162       | \$ | 74,913               |
| Correspondents               | 49,885           |    | 44,852               |
| Securities failed to receive | 28,002           |    | 5,523                |
| Clearing organizations       | 16,842           |    | 4,390                |
|                              | \$ 227,891       | \$ | 129,678              |

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

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

|                                  | Six Months Ended June 30, |           |
|----------------------------------|---------------------------|-----------|
|                                  | 2014                      | 2013      |
| Balance, beginning of period     | \$ 27,468                 | \$ 34,012 |
| Less reinsurance recoverables    | (4,508)                   | (10,385)  |
| Net balance, beginning of period | 22,960                    | 23,627    |
| <b>Incurring related to:</b>     |                           |           |
| Current period                   | 48,750                    | 68,602    |
| Prior periods                    | 4,862                     | 743       |
| Total incurred                   | 53,612                    | 69,345    |
| <b>Payments related to:</b>      |                           |           |

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|                               |           |           |
|-------------------------------|-----------|-----------|
| Current period                | (33,171)  | (44,678)  |
| Prior periods                 | (11,980)  | (11,604)  |
| Total payments                | (45,151)  | (56,282)  |
| Net balance, end of period    | 31,421    | 36,690    |
| Plus reinsurance recoverables | 3,725     | 5,768     |
| Balance, end of period        | \$ 35,146 | \$ 42,458 |

The decrease in the reserves at June 30, 2014 as compared to June 30, 2013 of \$7.3 million is primarily due to decreased reserves attributable to the decreased year-over-year severity of incurred tornado, wind and hail losses. Prior period adverse development of \$4.9 million during the six months ended June 30, 2014 was primarily related to litigation emerging from a series of hail storms within the 2012 accident year.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**19. Reinsurance Activity**

NLC limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risk. Substantial amounts of business are ceded, and these reinsurance contracts do not relieve NLC from its obligations to policyholders. Such reinsurance includes quota share, excess of loss, catastrophe, and other forms of reinsurance on essentially all property and casualty lines of insurance. Net insurance premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE and unearned insurance premiums ceded to them are reported as assets. Failure of reinsurers to honor their obligations could result in losses to NLC; consequently, allowances are established for amounts deemed uncollectible as NLC evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At June 30, 2014, reinsurance receivables have a carrying value of \$4.1 million, which is included in other assets within the consolidated balance sheet. There was no allowance for uncollectible accounts at June 30, 2014, based on NLC's quality requirements.

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

|                               | Three Months Ended June 30, |           |           |           | Six Months Ended June 30, |           |           |           |
|-------------------------------|-----------------------------|-----------|-----------|-----------|---------------------------|-----------|-----------|-----------|
|                               | 2014                        |           | 2013      |           | 2014                      |           | 2013      |           |
|                               | Written                     | Earned    | Written   | Earned    | Written                   | Earned    | Written   | Earned    |
| Premiums from direct business | \$ 47,999                   | \$ 43,534 | \$ 47,950 | \$ 41,943 | \$ 91,770                 | \$ 86,293 | \$ 89,807 | \$ 82,490 |
| Reinsurance assumed           | 2,677                       | 2,178     | 2,120     | 1,748     | 4,910                     | 4,198     | 3,873     | 3,378     |
| Reinsurance ceded             | (5,295)                     | (4,935)   | (5,224)   | (5,101)   | (9,481)                   | (9,395)   | (9,779)   | (9,805)   |
| Net premiums                  | \$ 45,381                   | \$ 40,777 | \$ 44,846 | \$ 38,590 | \$ 87,199                 | \$ 81,096 | \$ 83,901 | \$ 76,063 |

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

|                           | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|---------------------------|-----------------------------|-----------|---------------------------|-----------|
|                           | 2014                        | 2013      | 2014                      | 2013      |
| Loss and LAE incurred     | \$ 36,455                   | \$ 49,537 | \$ 54,207                 | \$ 70,949 |
| Reinsurance recoverables  | (1,180)                     | (1,377)   | (595)                     | (1,604)   |
| Net loss and LAE incurred | \$ 35,275                   | \$ 48,160 | \$ 53,612                 | \$ 69,345 |

*Multi-line excess of loss coverage*



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

### *Catastrophic coverage*

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

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



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|                                   | Banking    | Origination | Insurance | Advisory | Corporate  | Eliminations | Consolidated |
|-----------------------------------|------------|-------------|-----------|----------|------------|--------------|--------------|
| <b>Six Months Ended</b>           |            |             |           |          |            |              |              |
| <b>June 30, 2014</b>              |            |             |           |          |            |              |              |
| Net interest income (expense)     | \$ 170,401 | \$ (6,528)  | \$ 1,817  | \$ 5,808 | \$ 3,387   | \$ 8,982     | \$ 183,867   |
| Provision for loan losses         | 8,744      |             |           | 31       |            |              | 8,775        |
| Noninterest income                | 32,621     | 214,583     | 85,896    | 50,435   |            | (10,154)     | 373,381      |
| Noninterest expense               | 120,917    | 201,857     | 81,762    | 55,724   | 4,753      | (1,172)      | 463,841      |
| Income (loss) before income taxes | \$ 73,361  | \$ 6,198    | \$ 5,951  | \$ 488   | \$ (1,366) | \$           | \$ 84,632    |

|   | Banking   | Mortgage Origination | Insurance   | Financial Advisory | Corporate  | All Other and Eliminations | Hilltop Consolidated |
|---|-----------|----------------------|-------------|--------------------|------------|----------------------------|----------------------|
| <b>Three Months Ended June 30, 2013</b> |           |                      |             |                    |            |                            |                      |
| Net interest income (expense)           | \$ 68,597 | \$ (11,847)          | \$ 873      | \$ 3,511           | \$ (105)   | \$ 7,396                   | \$ 68,425            |
| Provision for loan losses               | 11,300    |                      |             | (11)               |            |                            | 11,289               |
| Noninterest income                      | 11,928    | 165,257              | 40,777      | 28,863             |            | (7,592)                    | 239,233              |
| Noninterest expense                     | 31,919    | 134,487              | 62,144      | 30,373             | 1,673      | (196)                      | 260,400              |
| Income (loss) before income taxes       | \$ 37,306 | \$ 18,923            | \$ (20,494) | \$ 2,012           | \$ (1,778) | \$                         | \$ 35,969            |

|                                       | Banking    | Mortgage Origination | Insurance   | Financial Advisory | Corporate  | All Other and Eliminations | Hilltop Consolidated |
|---------------------------------------|------------|----------------------|-------------|--------------------|------------|----------------------------|----------------------|
| <b>Six Months Ended June 30, 2013</b> |            |                      |             |                    |            |                            |                      |
| Net interest income (expense)         | \$ 136,268 | \$ (23,850)          | \$ 1,886    | \$ 6,754           | \$ (236)   | \$ 14,864                  | \$ 135,686           |
| Provision for loan losses             | 24,266     |                      |             | 28                 |            |                            | 24,294               |
| Noninterest income                    | 24,132     | 311,785              | 80,202      | 51,641             |            | (15,249)                   | 452,511              |
| Noninterest expense                   | 62,599     | 256,758              | 96,410      | 56,099             | 3,910      | (385)                      | 475,391              |
| Income (loss) before income taxes     | \$ 73,535  | \$ 31,177            | \$ (14,322) | \$ 2,268           | \$ (4,146) | \$                         | \$ 88,512            |

|                      |              |              |            |            |              |                |              |
|----------------------|--------------|--------------|------------|------------|--------------|----------------|--------------|
| <b>June 30, 2014</b> |              |              |            |            |              |                |              |
| Goodwill             | \$ 207,741   | \$ 13,071    | \$ 23,988  | \$ 7,008   | \$           | \$             | \$ 251,808   |
| Total assets         | \$ 8,223,370 | \$ 1,574,401 | \$ 326,478 | \$ 712,693 | \$ 1,402,816 | \$ (2,843,310) | \$ 9,396,448 |

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

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## Hilltop Holdings Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

(Unaudited)

**21. Earnings per Common Share**

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

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

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

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

|   | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|---|-----------------------------|-----------|---------------------------|-----------|
|   | 2014                        | 2013      | 2014                      | 2013      |
| Basic earnings per share:                             |                             |           |                           |           |
| Income applicable to Hilltop common stockholders      | \$ 27,085                   | \$ 20,943 | \$ 50,845                 | \$ 53,313 |
| Less: income applicable to participating shares       | (141)                       | (116)     | (266)                     | (295)     |
| Net earnings available to Hilltop common stockholders | \$ 26,944                   | \$ 20,827 | \$ 50,579                 | \$ 53,018 |
| Weighted average shares outstanding - basic           | 89,709                      | 83,490    | 89,708                    | 83,489    |

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|  |    |        |    |        |    |        |    |        |
|--|----|--------|----|--------|----|--------|----|--------|
| Basic earnings per common share                                    | \$ | 0.30   | \$ | 0.25   | \$ | 0.56   | \$ | 0.64   |
| Diluted earnings per share:  |    |        |    |        |    |        |    |        |
| Income applicable to Hilltop common stockholders                   | \$ | 27,085 | \$ | 20,943 | \$ | 50,845 | \$ | 53,313 |
| Add: interest expense on senior exchangeable notes<br>(net of tax) |    |        |    | 1,053  |    |        |    | 2,105  |
| Net earnings available to Hilltop common<br>stockholders           | \$ | 27,085 | \$ | 21,996 | \$ | 50,845 | \$ | 55,418 |
| Weighted average shares outstanding - basic                        |    | 89,709 |    | 83,490 |    | 89,708 |    | 83,489 |
| Effect of potentially dilutive securities                          |    | 860    |    | 6,804  |    | 868    |    | 6,636  |
| Weighted average shares outstanding - diluted                      |    | 90,569 |    | 90,294 |    | 90,576 |    | 90,125 |
| Diluted earnings per common share                                  | \$ | 0.30   | \$ | 0.24   | \$ | 0.56   | \$ | 0.61   |

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

**22. Recently Issued Accounting Standards**

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

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

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

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



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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

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

*Unless the context otherwise indicates, all references in this Quarterly Report, references to the Company, we, us, our or ours or similar words are to Hilltop Holdings Inc. and its direct and indirect wholly owned subsidiaries, references to Hilltop refer solely to Hilltop Holdings Inc., references to PlainsCapital refer to PlainsCapital Corporation (a wholly owned subsidiary of Hilltop), references to the Bank refer to PlainsCapital Bank (a wholly owned subsidiary of PlainsCapital), references to FNB refer to First National Bank, references to First Southwest refer to First Southwest Holdings, LLC (a wholly owned subsidiary of the Bank) and its subsidiaries as a whole, references to FSC refer to First Southwest Company (a wholly owned subsidiary of First Southwest), references to PrimeLending refer to PrimeLending, a PlainsCapital Company (a wholly owned subsidiary of the Bank) and its subsidiaries as a whole and references to NLC refer to National Lloyds Corporation (a wholly owned subsidiary of Hilltop) and its subsidiaries as a whole.*

**FORWARD-LOOKING STATEMENTS**

This Quarterly Report and the documents incorporated by reference into this report include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this Quarterly Report that address results or developments that we expect or anticipate will or may occur in the future, and statements that are preceded by, followed by or include, words such as anticipates, believes, could, estimates, expects, forecasts, goal, intends, may, probable, projects, seeks, should, target, view or would or the negative of these words and phrases or similar words or phrases, including things as our business strategy, our financial condition, our litigation, our efforts to make strategic acquisitions, our pending acquisition of SWS Group, Inc. ( SWS ), our revenue, our liquidity and sources of funding, market trends, operations and business, expectations concerning mortgage loan origination volume, anticipated changes in our revenues or earnings, the effects of government regulation applicable to our operations, the appropriateness of our allowance for loan losses and provision for loan losses, and the collectability of loans are forward-looking statements.

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

- risks related to our pending acquisition of SWS;
- risks associated with merger and acquisition integration, including the assets and liabilities of FNB and SWS;



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

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

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

**OVERVIEW**

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

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

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

At June 30, 2014, on a consolidated basis, we had total assets of \$9.4 billion, total deposits of \$6.2 billion, total loans, including loans held for sale, of \$6.0 billion and stockholders' equity of \$1.4 billion. Our banking operations include the operations acquired in the FNB Transaction since September 14, 2013.

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***Segment Information***

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

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

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

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

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

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



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

|   | Banking   | Mortgage Origination | Insurance  | Financial Advisory | Corporate | All Other and Eliminations | Hilltop Consolidated |
|---|-----------|----------------------|------------|--------------------|-----------|----------------------------|----------------------|
| <b>Three Months Ended June 30, 2014</b> |           |                      |            |                    |           |                            |                      |
| Net interest income (expense)           | \$ 90,828 | \$ (2,389)           | \$ 838     | \$ 3,178           | \$ 1,695  | \$ 4,296                   | \$ 98,446            |
| Provision for loan losses               | 5,516     |                      |            | 17                 |           |                            | 5,533                |
| Noninterest income                      | 16,392    | 122,820              | 43,123     | 25,838             |           | (4,892)                    | 203,281              |
| Noninterest expense                     | 60,240    | 111,224              | 49,420     | 28,359             | 2,565     | (596)                      | 251,212              |
| Income (loss) before income taxes       | \$ 41,464 | \$ 9,207             | \$ (5,459) | \$ 640             | \$ (870)  | \$                         | \$ 44,982            |

|                                       | Banking    | Mortgage Origination | Insurance | Financial Advisory | Corporate  | All Other and Eliminations | Hilltop Consolidated |
|---------------------------------------|------------|----------------------|-----------|--------------------|------------|----------------------------|----------------------|
| <b>Six Months Ended June 30, 2014</b> |            |                      |           |                    |            |                            |                      |
| Net interest income (expense)         | \$ 170,401 | \$ (6,528)           | \$ 1,817  | \$ 5,808           | \$ 3,387   | \$ 8,982                   | \$ 183,867           |
| Provision for loan losses             | 8,744      |                      |           | 31                 |            |                            | 8,775                |
| Noninterest income                    | 32,621     | 214,583              | 85,896    | 50,435             |            | (10,154)                   | 373,381              |
| Noninterest expense                   | 120,917    | 201,857              | 81,762    | 55,724             | 4,753      | (1,172)                    | 463,841              |
| Income (loss) before income taxes     | \$ 73,361  | \$ 6,198             | \$ 5,951  | \$ 488             | \$ (1,366) | \$                         | \$ 84,632            |

|   | Banking   | Mortgage Origination | Insurance   | Financial Advisory | Corporate  | All Other and Eliminations | Hilltop Consolidated |
|---|-----------|----------------------|-------------|--------------------|------------|----------------------------|----------------------|
| <b>Three Months Ended June 30, 2013</b> |           |                      |             |                    |            |                            |                      |
| Net interest income (expense)           | \$ 68,597 | \$ (11,847)          | \$ 873      | \$ 3,511           | \$ (105)   | \$ 7,396                   | \$ 68,425            |
| Provision for loan losses               | 11,300    |                      |             | (11)               |            |                            | 11,289               |
| Noninterest income                      | 11,928    | 165,257              | 40,777      | 28,863             |            | (7,592)                    | 239,233              |
| Noninterest expense                     | 31,919    | 134,487              | 62,144      | 30,373             | 1,673      | (196)                      | 260,400              |
| Income (loss) before income taxes       | \$ 37,306 | \$ 18,923            | \$ (20,494) | \$ 2,012           | \$ (1,778) | \$                         | \$ 35,969            |

|                                       | Banking    | Mortgage Origination | Insurance   | Financial Advisory | Corporate  | All Other and Eliminations | Hilltop Consolidated |
|---------------------------------------|------------|----------------------|-------------|--------------------|------------|----------------------------|----------------------|
| <b>Six Months Ended June 30, 2013</b> |            |                      |             |                    |            |                            |                      |
| Net interest income (expense)         | \$ 136,268 | \$ (23,850)          | \$ 1,886    | \$ 6,754           | \$ (236)   | \$ 14,864                  | \$ 135,686           |
| Provision for loan losses             | 24,266     |                      |             | 28                 |            |                            | 24,294               |
| Noninterest income                    | 24,132     | 311,785              | 80,202      | 51,641             |            | (15,249)                   | 452,511              |
| Noninterest expense                   | 62,599     | 256,758              | 96,410      | 56,099             | 3,910      | (385)                      | 475,391              |
| Income (loss) before income taxes     | \$ 73,535  | \$ 31,177            | \$ (14,322) | \$ 2,268           | \$ (4,146) | \$                         | \$ 88,512            |

### *How We Generate Revenue*

We generate revenue from net interest income and from noninterest income. Net interest income represents the difference between the income earned on our assets, including our loans and investment securities, and our cost of funds, including the interest paid on the deposits and borrowings that are used to support our assets. Net interest income is a significant contributor to our operating results. Fluctuations in interest rates, as well as the amounts and types of interest-earning assets and interest-bearing liabilities we hold, affect net interest income. We generated \$183.9 million in net interest income during the six months ended June 30, 2014, compared with net interest income of \$135.7 million during the same period in 2013. The year-over-year increase in net interest income was primarily due to the inclusion of those operations acquired as a part of the FNB Transaction within our banking segment.

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

(i) *Income from mortgage operations.* Through our wholly owned subsidiary, PrimeLending, we generate noninterest income by originating and selling mortgage loans. During the six months ended June 30, 2014 and 2013, we generated \$214.5 million and \$311.7 million, respectively, in net gains from the sale of loans, other mortgage production income (including income associated with retained mortgage servicing rights), and mortgage loan origination fees.

(ii) *Net insurance premiums earned.* Through our wholly owned insurance subsidiary, NLC, we provide fire and limited homeowners insurance for low value dwellings and manufactured homes. We generated \$81.1 million in net insurance premiums earned during the six months ended June 30, 2014, compared with \$76.1 million during the same period in the prior year.

(iii) *Investment advisory fees and commissions and securities brokerage fees and commissions.* Through our wholly owned subsidiary, First Southwest, we provide public finance advisory and various investment banking and brokerage services. We generated \$43.6 million and \$48.0 million in investment advisory fees and commissions and securities brokerage fees and commissions during the six months ended June 30, 2014 and 2013, respectively.

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In the aggregate, we generated \$373.4 million and \$452.5 million in noninterest income during the six months ended June 30, 2014 and 2013, respectively. The significant year-over-year decrease in noninterest income was primarily due to the decrease in loan origination volume within our mortgage origination segment, partially offset by increases in noninterest income in our banking and insurance segments.

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

**Consolidated Operating Results**

Net income applicable to common stockholders for the three months ended June 30, 2014 was \$27.1 million, or \$0.30 per diluted share, compared to net income applicable to common stockholders of \$20.9 million, or \$0.24 per diluted share, for the three months ended June 30, 2013. Net income applicable to common stockholders for the six months ended June 30, 2014 was \$50.8 million, or \$0.56 per diluted share, compared to net income applicable to common stockholders of \$53.3 million, or \$0.61 per diluted share, for the six months ended June 30, 2013.

Certain items included in net income for 2013 and 2014 resulted from purchase accounting associated with the merger of PlainsCapital Corporation with and into a wholly owned subsidiary of Hilltop on November 30, 2012 (the PlainsCapital Merger) and the FNB Transaction. Income before taxes for the three months ended June 30, 2014 includes net accretion of \$17.0 million and \$10.4 million on earning assets and liabilities acquired in the PlainsCapital Merger and FNB Transaction, respectively, offset by amortization of identifiable intangibles of \$2.3 million and \$0.3 million, respectively. During the three months ended June 30, 2013, income before taxes includes net accretion of \$15.9 million on earning assets and liabilities acquired in the PlainsCapital Merger, offset by amortization of identifiable intangibles of \$2.5 million. Income before taxes for the six months ended June 30, 2014 includes net accretion of \$27.0 million and \$19.9 million on earning assets and liabilities acquired in the PlainsCapital Merger and FNB Transaction, respectively, offset by amortization of identifiable intangibles of \$4.6 million and \$0.5 million, respectively. During the six months ended June 30, 2013, income before taxes includes net accretion of \$31.9 million on earning assets and liabilities acquired in the PlainsCapital Merger, offset by amortization of identifiable intangibles of \$4.9 million.

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

|  | Three Months Ended June 30,<br>2014 | Three Months Ended June 30,<br>2013 | Six Months Ended June 30,<br>2014 | Six Months Ended June 30,<br>2013 | Year Ended<br>December 31, 2013 |
|--|-------------------------------------|-------------------------------------|-----------------------------------|-----------------------------------|---------------------------------|
| <b>Performance Ratios:</b>                   |                                     |                                     |                                   |                                   |                                 |
| Return on average stockholders' equity       | 7.99%                               | 7.29%                               | 7.82%                             | 9.46%                             | 10.48%                          |
| Return on average assets                     | 1.24%                               | 1.24%                               | 1.19%                             | 1.58%                             | 1.66%                           |
| Net interest margin (taxable equivalent) (1) | 5.18%                               | 4.33%                               | 4.90%                             | 4.34%                             | 4.47%                           |

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

During the three months ended June 30, 2014, the consolidated taxable equivalent net interest margin of 5.18% was impacted by PlainsCapital Merger related accretion of discount on loans of \$17.8 million, amortization of premium on acquired securities of \$1.0 million and amortization



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of premium on acquired time deposits of \$0.2 million. Additionally, FNB Transaction related accretion of discount on loans of \$8.1 million and amortization of premium on acquired time deposits of \$2.3 million also impacted the consolidated taxable equivalent net interest margin during the three months ended June 30, 2014. These items increased the consolidated taxable equivalent net interest margin by 140 basis points for the three months ended June 30, 2014. The consolidated taxable equivalent net interest margin was 4.33% for the three months ended June 30, 2013. The taxable equivalent net interest margin for the second quarter of 2013 was impacted by PlainsCapital Merger related accretion of discount on loans of \$16.7 million, amortization of premium on acquired securities of \$1.4 million and amortization of premium on acquired time deposits of \$0.6 million. These items increased the consolidated taxable equivalent interest margin by 98 basis points for the three months ended June 30, 2013.

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During the six months ended June 30, 2014, the consolidated taxable equivalent net interest margin of 4.90% was impacted by PlainsCapital Merger related accretion of discount on loans of \$28.6 million, amortization of premium on acquired securities of \$1.9 million and amortization of premium on acquired time deposits of \$0.3 million. Additionally, FNB Transaction related accretion of discount on loans of \$15.3 million and amortization of premium on acquired time deposits of \$4.6 million also impacted the consolidated taxable equivalent net interest margin during the six months ended June 30, 2014. These items increased the consolidated taxable equivalent net interest margin by 121 basis points for the six months ended June 30, 2014. The consolidated taxable equivalent net interest margin was 4.34% for the six months ended June 30, 2013. The taxable equivalent net interest margin for the six months ended June 30, 2013 was impacted by PlainsCapital Merger related accretion of discount on loans of \$33.6 million, amortization of premium on acquired securities of \$3.4 million and amortization of premium on acquired time deposits of \$1.7 million. These items increased the consolidated taxable equivalent interest margin by 97 basis points for the six months ended June 30, 2013.

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

| Table of Contents  |    |                  |    |         |       |    |                  |    |        |       |
|--|----|------------------|----|---------|-------|----|------------------|----|--------|-------|
| <b>Assets</b>  |    |                  |    |         |       |    |                  |    |        |       |
| Interest-earning assets  |    |                  |    |         |       |    |                  |    |        |       |
| Loans, gross (1)   | \$ | 5,526,869        | \$ | 92,204  | 6.63% | \$ | 4,352,489        | \$ | 65,213 | 5.95% |
| Investment securities - taxable  |    | 1,144,269        |    | 7,618   | 2.66% |    | 996,624          |    | 6,480  | 2.60% |
| Investment securities - non-taxable (2)                                |    | 185,533          |    | 1,772   | 3.82% |    | 201,383          |    | 1,772  | 3.52% |
| Federal funds sold and securities purchased under agreements to resell |    | 20,308           |    | 14      | 0.28% |    | 34,594           |    | 35     | 0.40% |
| Interest-bearing deposits in other financial institutions              |    | 575,653          |    | 317     | 0.22% |    | 581,676          |    | 242    | 0.25% |
| Other  |    | 218,413          |    | 3,068   | 5.62% |    | 164,754          |    | 3,009  | 7.31% |
| Interest-earning assets, gross   |    | 7,671,045        |    | 104,993 | 5.44% |    | 6,331,520        |    | 76,751 | 4.82% |
| Allowance for loan losses  |    | (38,909)         |    |         |       |    | (20,588)         |    |        |       |
| Interest-earning assets, net   |    | 7,632,136        |    |         |       |    | 6,310,932        |    |        |       |
| Noninterest-earning assets   |    | 1,304,522        |    |         |       |    | 818,914          |    |        |       |
| <b>Total assets</b>  | \$ | <b>8,936,658</b> |    |         |       | \$ | <b>7,129,846</b> |    |        |       |
| <b>Liabilities and Stockholders Equity</b>                             |    |                  |    |         |       |    |                  |    |        |       |
| Interest-bearing liabilities   |    |                  |    |         |       |    |                  |    |        |       |
| Interest-bearing deposits  | \$ | 4,523,194        | \$ | 3,096   | 0.27% | \$ | 3,379,302        | \$ | 3,406  | 0.40% |
| Notes payable and other borrowings                                     |    | 966,143          |    | 2,866   | 1.18% |    | 1,044,784        |    | 4,337  | 1.66% |
| Total interest-bearing liabilities                                     |    | 5,489,337        |    | 5,962   | 0.43% |    | 4,424,086        |    | 7,743  | 0.70% |
| Noninterest-bearing liabilities  |    |                  |    |         |       |    |                  |    |        |       |
| Noninterest-bearing deposits   |    | 1,761,194        |    |         |       |    | 1,179,264        |    |        |       |
| Other liabilities  |    | 307,846          |    |         |       |    | 341,929          |    |        |       |
| Total liabilities  |    | 7,558,377        |    |         |       |    | 5,945,279        |    |        |       |
| Stockholders equity  |    | 1,377,769        |    |         |       |    | 1,183,830        |    |        |       |
| Noncontrolling interest  |    | 512              |    |         |       |    | 737              |    |        |       |
| <b>Total liabilities and stockholders equity</b>                       | \$ | <b>8,936,658</b> |    |         |       | \$ | <b>7,129,846</b> |    |        |       |
| <b>Net interest income (2)</b>   |    |                  | \$ | 99,031  |       |    |                  | \$ | 69,008 |       |
| <b>Net interest spread (2)</b>   |    |                  |    |         | 5.01% |    |                  |    |        | 4.12% |
| <b>Net interest margin (2)</b>   |    |                  |    |         | 5.18% |    |                  |    |        | 4.33% |



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|   | Six Months Ended June 30,         |                                       |                                |                                   |                                       |                                |
|---|-----------------------------------|---------------------------------------|--------------------------------|-----------------------------------|---------------------------------------|--------------------------------|
|   | Average<br>Outstanding<br>Balance | 2014<br>Interest<br>Earned or<br>Paid | Annualized<br>Yield or<br>Rate | Average<br>Outstanding<br>Balance | 2013<br>Interest<br>Earned or<br>Paid | Annualized<br>Yield or<br>Rate |
| <b>Assets</b>   |                                   |                                       |                                |                                   |                                       |                                |
| Interest-earning assets   |                                   |                                       |                                |                                   |                                       |                                |
| Loans, gross (1)  | \$ 5,299,145                      | \$ 171,948                            | 6.47%                          | \$ 4,280,580                      | \$ 130,099                            | 6.06%                          |
| Investment securities - taxable   | 1,133,315                         | 15,206                                | 2.69%                          | 948,789                           | 12,392                                | 2.61%                          |
| Investment securities - non-taxable (2)                                   | 184,345                           | 3,633                                 | 3.94%                          | 209,816                           | 3,794                                 | 3.62%                          |
| Federal funds sold and securities<br>purchased under agreements to resell | 23,305                            | 33                                    | 0.28%                          | 22,462                            | 56                                    | 0.50%                          |
| Interest-bearing deposits in other<br>financial institutions              | 770,206                           | 912                                   | 0.24%                          | 664,002                           | 575                                   | 0.25%                          |
| Other   | 203,428                           | 5,708                                 | 5.64%                          | 159,685                           | 5,114                                 | 6.45%                          |
| Interest-earning assets, gross  | 7,613,744                         | 197,440                               | 5.17%                          | 6,285,334                         | 152,030                               | 4.83%                          |
| Allowance for loan losses   | (37,891)                          |                                       |                                | (13,720)                          |                                       |                                |
| Interest-earning assets, net  | 7,575,853                         |                                       |                                | 6,271,614                         |                                       |                                |
| Noninterest-earning assets  | 1,336,127                         |                                       |                                | 845,500                           |                                       |                                |
| <b>Total assets</b>   | <b>\$ 8,911,980</b>               |                                       |                                | <b>\$ 7,117,114</b>               |                                       |                                |
| <b>Liabilities and Stockholders Equity</b>                                |                                   |                                       |                                |                                   |                                       |                                |
| Interest-bearing liabilities  |                                   |                                       |                                |                                   |                                       |                                |
| Interest-bearing deposits   | \$ 4,735,026                      | \$ 6,855                              | 0.29%                          | \$ 3,468,202                      | \$ 6,856                              | 0.40%                          |
| Notes payable and other borrowings  | 815,942                           | 5,514                                 | 1.35%                          | 948,138                           | 8,230                                 | 1.74%                          |
| Total interest-bearing liabilities  | 5,550,968                         | 12,369                                | 0.45%                          | 4,416,340                         | 15,086                                | 0.69%                          |
| Noninterest-bearing liabilities   |                                   |                                       |                                |                                   |                                       |                                |
| Noninterest-bearing deposits  | 1,741,409                         |                                       |                                | 1,184,990                         |                                       |                                |
| Other liabilities   | 264,504                           |                                       |                                | 343,915                           |                                       |                                |
| Total liabilities   | 7,556,881                         |                                       |                                | 5,945,245                         |                                       |                                |
| Stockholders equity   | 1,354,635                         |                                       |                                | 1,171,132                         |                                       |                                |
| Noncontrolling interest   | 464                               |                                       |                                | 737                               |                                       |                                |
| <b>Total liabilities and stockholders<br/>equity</b>                      | <b>\$ 8,911,980</b>               |                                       |                                | <b>\$ 7,117,114</b>               |                                       |                                |
| <b>Net interest income (2)</b>  |                                   | <b>\$ 185,071</b>                     |                                |                                   | <b>\$ 136,944</b>                     |                                |
| <b>Net interest spread (2)</b>  |                                   |                                       | <b>4.72%</b>                   |                                   |                                       | <b>4.14%</b>                   |
| <b>Net interest margin (2)</b>  |                                   |                                       | <b>4.90%</b>                   |                                   |                                       | <b>4.34%</b>                   |

(1) Average balance includes non-accrual loans.

(2) Annualized taxable equivalent adjustments are based on a 35% tax rate. The adjustment to interest income was \$0.6 million for each of the three months ended June 30, 2014 and 2013, respectively, and \$1.2 million and \$1.3 million for the six months ended June 30, 2014 and 2013, respectively.

On a consolidated basis, net interest income increased \$30.0 million and \$48.2 million during the three and six months ended June 30, 2014, compared with the same periods in 2013. These increases were primarily due to the inclusion of those operations acquired as a part of the FNB Transaction within our banking segment.

The provision for loan losses is determined by management as the amount to be added to the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable losses within the existing

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loan portfolio. The consolidated provision for loan losses, primarily in the banking segment, was \$5.5 million and \$11.3 million during the three months ended June 30, 2014 and 2013, respectively. During the three months ended June 30, 2014 and 2013, the provision for loan losses was comprised of charges relating to newly originated loans and acquired loans without credit impairment at acquisition of \$3.9 million and \$11.0 million, respectively, and purchased credit impaired ( PCI ) loans of \$1.6 million and \$0.3 million, respectively. During the six months ended June 30, 2014 and 2013, the consolidated provision for loan losses, primarily in the banking segment, was \$8.8 million and \$24.3 million, respectively. The provision for loan losses during the six months ended June 30, 2014 and 2013 was comprised of charges relating to newly originated loans and acquired loans without credit impairment at acquisition of \$5.3 million and \$23.6 million, respectively, and PCI loans of \$3.5 million and \$0.7 million, respectively.

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Consolidated noninterest income decreased \$36.0 million and \$79.1 million during the three and six months ended June 30, 2014, compared with the same periods in 2013. These year-over-year decreases were primarily related to the reduction in net gains from sale of loans, other mortgage production income and mortgage loan origination fees within our mortgage origination segment of \$42.2 million and \$97.2 million, respectively, slightly offset by increases in noninterest income in our banking and insurance segments.

Our consolidated noninterest expense during the three and six months ended June 30, 2014 decreased \$9.2 million and \$11.6 million, respectively, compared with the same periods in 2013. These year-over-year decreases included significant increases in noninterest expenses within our banking segment of \$28.3 million and \$58.3 million, respectively, primarily due to the inclusion of those operations acquired as part of the FNB Transaction, which were offset by significant decreases in noninterest expenses within our mortgage origination segment of \$23.3 million and \$54.9 million, respectively, primarily due to reductions in variable compensation tied to mortgage loan originations. Changes between the six months ended June 30, 2014 and 2013 within the major components of noninterest expense included decreases of \$18.0 million in employees' compensation and benefits and \$15.7 million in loss and loss adjustment expenses, partially offset by increases of \$12.5 million in occupancy and equipment and \$8.8 million in other expenses.

Consolidated income tax expense during the three months ended June 30, 2014 and 2013 was \$16.3 million and \$13.3 million, respectively, reflecting effective rates of 36.2% and 37.0%, respectively. During the six months ended June 30, 2014 and 2013, consolidated income tax expense was \$30.6 million and \$32.5 million, respectively, reflecting effective rates of 36.2% and 36.7%, respectively.

***Segment Results***

**Banking Segment**

Income before income taxes in our banking segment for the three months ended June 30, 2014 and 2013 was \$41.5 million and \$37.3 million, respectively. Income before income taxes increased in the three months ended June 30, 2014, compared with the same period in 2013, due to increases in net interest income and noninterest income, and a decrease in the provision for loan losses, all of which were partially offset by increases in noninterest expense. Income before income taxes in our banking segment for the six months ended June 30, 2014 and 2013 was \$73.4 million and \$73.5 million, respectively. Income before taxes in the six months ended June 30, 2014 was comparable to the same period in 2013. The operations acquired as a part of the FNB Transaction had a significant effect on each of the components of income before income taxes during both the three and six months ended June 30, 2014, compared to the same periods in 2013.

At June 30, 2014, the Bank exceeded all regulatory capital requirements with a total capital to risk weighted assets ratio of 13.90%, Tier 1 capital to risk weighted assets ratio of 13.22% and a Tier 1 capital to average assets, or leverage, ratio of 9.97%. At June 30, 2014, the Bank was also considered to be well-capitalized under regulatory requirements without giving effect to the final capital rules adopted by the Federal Reserve Board on July 2, 2013 ( Basel III ). For additional discussion of the final Basel III capital rules and their impact on our Company, see the section entitled Liquidity and Capital Resources Regulatory Capital below.

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

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|  | Three Months Ended June 30, |        | Six Months Ended June 30, |        | Year Ended        |
|--|-----------------------------|--------|---------------------------|--------|-------------------|
|  | 2014                        | 2013   | 2014                      | 2013   | December 31, 2013 |
| <b>Performance Ratios:</b>                   |                             |        |                           |        |                   |
| Efficiency ratio (1)                         | 56.18%                      | 39.64% | 59.56%                    | 39.03% | 42.58%            |
| Return on average assets                     | 1.36%                       | 1.62%  | 1.20%                     | 1.65%  | 1.78%             |
| Net interest margin (taxable equivalent) (2) | 5.52%                       | 5.20%  | 5.16%                     | 5.21%  | 5.17%             |

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

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

During the three months ended June 30, 2014, the banking segment's taxable equivalent net interest margin of 5.52% was impacted by PlainsCapital Merger related accretion of discount on loans of \$17.8 million, amortization of premium on acquired securities of \$1.0 million and amortization of premium on acquired time deposits of \$0.2 million. Additionally,

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FNB Transaction related accretion of discount on loans of \$8.1 million and amortization of premium on acquired time deposits of \$2.3 million also impacted the banking segment's taxable equivalent net interest margin during the three months ended June 30, 2014. These items increased the banking segment's taxable equivalent net interest margin by 162 basis points for the three months ended June 30, 2014. The banking segment's taxable equivalent net interest margin for the three months ended June 30, 2013 of 5.20% was impacted by PlainsCapital Merger related accretion of discount on loans of \$16.7 million, amortization of premium on acquired securities of \$1.4 million and amortization of premium on acquired time deposits of \$0.6 million. These items increased the banking segment's taxable equivalent interest margin by 119 basis points for three months ended June 30, 2013.

During the six months ended June 30, 2014, the banking segment's taxable equivalent net interest margin of 5.16% was impacted by PlainsCapital Merger related accretion of discount on loans of \$28.6 million, amortization of premium on acquired securities of \$1.9 million and amortization of premium on acquired time deposits of \$0.3 million. Additionally, FNB Transaction related accretion of discount on loans of \$15.3 million and amortization of premium on acquired time deposits of \$4.6 million also impacted the banking segment's taxable equivalent net interest margin during the six months ended June 30, 2014. These items increased the banking segment's taxable equivalent net interest margin by 138 basis points for the six months ended June 30, 2014. The banking segment's taxable equivalent net interest margin for the six months ended June 30, 2013 of 5.21% was impacted by PlainsCapital Merger related accretion of discount on loans of \$33.6 million, amortization of premium on acquired securities of \$3.4 million and amortization of premium on acquired time deposits of \$1.7 million. These items increased the banking segment's taxable equivalent interest margin by 120 basis points for six months ended June 30, 2013.

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

| <b>Assets</b>  |                     |           |       |                     |           |       |  |
|--|---------------------|-----------|-------|---------------------|-----------|-------|--|
| Interest-earning assets  |                     |           |       |                     |           |       |  |
| Loans, gross (1)   | \$ 4,216,648        | \$ 80,173 | 7.55% | \$ 2,949,314        | \$ 53,435 | 7.18% |  |
| Subsidiary warehouse lines of credit                                   | 901,125             | 8,229     | 3.61% | 1,002,847           | 14,328    | 5.65% |  |
| Investment securities - taxable  | 913,494             | 4,561     | 2.00% | 797,472             | 3,461     | 1.74% |  |
| Investment securities - non-taxable (2)                                | 152,042             | 1,476     | 3.88% | 158,075             | 1,383     | 3.50% |  |
| Federal funds sold and securities purchased under agreements to resell | 20,308              | 14        | 0.28% | 31,348              | 22        | 0.28% |  |
| Interest-bearing deposits in other financial institutions              | 406,773             | 256       | 0.25% | 323,095             | 211       | 0.26% |  |
| Other  | 42,871              | 411       | 3.84% | 42,304              | 385       | 3.64% |  |
| Interest-earning assets, gross   | 6,653,261           | 95,120    | 5.68% | 5,304,455           | 73,225    | 5.47% |  |
| Allowance for loan losses  | (38,745)            |           |       | (20,421)            |           |       |  |
| Interest-earning assets, net   | 6,614,516           |           |       | 5,284,034           |           |       |  |
| Noninterest-earning assets   | 1,260,740           |           |       | 783,049             |           |       |  |
| <b>Total assets</b>  | <b>\$ 7,875,256</b> |           |       | <b>\$ 6,067,083</b> |           |       |  |
| <b>Liabilities and Stockholders</b>                                    |                     |           |       |                     |           |       |  |
| <b>Equity</b>  |                     |           |       |                     |           |       |  |
| Interest-bearing liabilities   |                     |           |       |                     |           |       |  |
| Interest-bearing deposits  | \$ 4,500,603        | \$ 3,112  | 0.28% | \$ 3,354,713        | \$ 3,384  | 0.40% |  |
| Notes payable and other borrowings                                     | 597,977             | 392       | 0.26% | 537,821             | 376       | 0.28% |  |
| Total interest-bearing liabilities (3)                                 | 5,098,580           | 3,504     | 0.28% | 3,892,534           | 3,760     | 0.39% |  |



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|  |                  |       |                  |
|--|------------------|-------|------------------|
| <b>Noninterest-bearing liabilities</b>           |                  |       |                  |
| Noninterest-bearing deposits                     | 1,706,187        |       | 1,264,331        |
| Other liabilities                                | 31,748           |       | 34,929           |
| <b>Total liabilities</b>                         | <b>6,836,515</b> |       | <b>5,191,794</b> |
| Stockholders equity                              | 1,038,741        |       | 875,289          |
| <b>Total liabilities and stockholders equity</b> |                  |       |                  |
|  | \$ 7,875,256     |       | \$ 6,067,083     |
| <b>Net interest income (2)</b>                   |                  |       |                  |
|  | \$ 91,616        |       | \$ 69,465        |
| <b>Net interest spread (2)</b>                   |                  |       |                  |
|  |                  | 5.40% | 5.08%            |
| <b>Net interest margin (2)</b>                   |                  |       |                  |
|  |                  | 5.52% | 5.20%            |

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|   | Six Months Ended June 30,         |                                       |                                |                                   |                                       |                                |
|---|-----------------------------------|---------------------------------------|--------------------------------|-----------------------------------|---------------------------------------|--------------------------------|
|   | Average<br>Outstanding<br>Balance | 2014<br>Interest<br>Earned or<br>Paid | Annualized<br>Yield or<br>Rate | Average<br>Outstanding<br>Balance | 2013<br>Interest<br>Earned or<br>Paid | Annualized<br>Yield or<br>Rate |
| <b>Assets</b>   |                                   |                                       |                                |                                   |                                       |                                |
| Interest-earning assets   |                                   |                                       |                                |                                   |                                       |                                |
| Loans, gross (1)  | \$ 4,231,309                      | \$ 150,894                            | 7.11%                          | \$ 2,924,774                      | \$ 107,244                            | 7.30%                          |
| Subsidiary warehouse lines of credit                                      | 769,643                           | 15,161                                | 3.92%                          | 992,244                           | 28,215                                | 5.66%                          |
| Investment securities - taxable   | 905,127                           | 8,956                                 | 1.98%                          | 742,512                           | 6,178                                 | 1.66%                          |
| Investment securities - non-taxable (2)                                   | 153,048                           | 2,971                                 | 3.88%                          | 162,290                           | 2,812                                 | 3.47%                          |
| Federal funds sold and securities<br>purchased under agreements to resell | 23,305                            | 33                                    | 0.28%                          | 20,020                            | 28                                    | 0.28%                          |
| Interest-bearing deposits in other<br>financial institutions              | 600,960                           | 769                                   | 0.26%                          | 403,745                           | 524                                   | 0.26%                          |
| Other   | 36,016                            | 812                                   | 4.51%                          | 31,269                            | 550                                   | 3.52%                          |
| Interest-earning assets, gross  | 6,719,408                         | 179,596                               | 5.33%                          | 5,276,854                         | 145,551                               | 5.49%                          |
| Allowance for loan losses   | (37,733)                          |                                       |                                | (13,568)                          |                                       |                                |
| Interest-earning assets, net  | 6,681,675                         |                                       |                                | 5,263,286                         |                                       |                                |
| Noninterest-earning assets  | 1,265,809                         |                                       |                                | 798,492                           |                                       |                                |
| <b>Total assets</b>   | <b>\$ 7,947,484</b>               |                                       |                                | <b>\$ 6,061,778</b>               |                                       |                                |
| <b>Liabilities and Stockholders Equity</b>                                |                                   |                                       |                                |                                   |                                       |                                |
| Interest-bearing liabilities  |                                   |                                       |                                |                                   |                                       |                                |
| Interest-bearing deposits   | \$ 4,724,047                      | \$ 6,897                              | 0.29%                          | \$ 3,425,592                      | \$ 6,816                              | 0.40%                          |
| Notes payable and other borrowings  | 474,797                           | 717                                   | 0.30%                          | 452,542                           | 729                                   | 0.32%                          |
| Total interest-bearing liabilities (3)                                    | 5,198,844                         | 7,614                                 | 0.30%                          | 3,878,134                         | 7,545                                 | 0.39%                          |
| Noninterest-bearing liabilities   |                                   |                                       |                                |                                   |                                       |                                |
| Noninterest-bearing deposits  | 1,703,019                         |                                       |                                | 1,264,024                         |                                       |                                |
| Other liabilities   | 25,169                            |                                       |                                | 58,639                            |                                       |                                |
| Total liabilities   | 6,927,032                         |                                       |                                | 5,200,797                         |                                       |                                |
| Stockholders equity   | 1,020,452                         |                                       |                                | 860,981                           |                                       |                                |
| <b>Total liabilities and stockholders<br/>equity</b>                      | <b>\$ 7,947,484</b>               |                                       |                                | <b>\$ 6,061,778</b>               |                                       |                                |
| <b>Net interest income (2)</b>  |                                   | <b>\$ 171,982</b>                     |                                |                                   | <b>\$ 138,006</b>                     |                                |
| <b>Net interest spread (2)</b>  |                                   |                                       | <b>5.03%</b>                   |                                   |                                       | <b>5.10%</b>                   |
| <b>Net interest margin (2)</b>  |                                   |                                       | <b>5.16%</b>                   |                                   |                                       | <b>5.21%</b>                   |

(1) Average balance includes non-accrual loans.

(2) Annualized taxable equivalent adjustments are based on a 35% tax rate. The adjustment to interest income was \$0.5 million for each of the three months ended June 30, 2014 and 2013, respectively, and \$1.0 million for each of the six months ended June 30, 2014 and 2013, respectively.

(3) Excludes the allocation of interest expense on PlainsCapital debt of \$0.3 million for each of the three months ended June 30, 2014 and 2013 and \$0.6 million and \$0.5 million for the six months ended June 30, 2014 and 2013.

The banking segment's net interest margin shown above exceeds our consolidated net interest margin. Our consolidated net interest margin includes the yields and costs associated with certain items within interest-earning assets and interest-bearing liabilities in the financial advisory segment, as well as the borrowing costs of Hilltop and PlainsCapital, both of which reduce our consolidated net interest margin. In addition, the banking segment's interest earning assets include lines of credit extended to subsidiaries, the yields on which increase the banking segment's net interest margin. Such yields and costs are eliminated from the consolidated financial statements.



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

|  | Three Months Ended June 30,<br>2014 v. 2013 |                 |                  | Six Months Ended June 30,<br>2014 v. 2013 |                   |                  |
|--|---|-----------------|------------------|---|-------------------|------------------|
|  | Change Due To (1)                           |                 | Change           | Change Due To (1)                         |                   | Change           |
|  | Volume                                      | Yield/Rate      |                  | Volume                                    | Yield/Rate        |                  |
| <b>Interest income</b>   |   |                 |                  |   |                   |                  |
| Loans, gross   | \$ 22,749                                   | \$ 3,989        | \$ 26,738        | \$ 47,692                                 | \$ (4,042)        | \$ 43,650        |
| Subsidiary warehouse lines of credit                                   | (1,437)                                     | (4,662)         | (6,099)          | (6,295)                                   | (6,759)           | (13,054)         |
| Investment securities - taxable  | 504   | 596             | 1,100            | 1,353                                     | 1,425             | 2,778            |
| Investment securities - non-taxable (2)                                | (53)  | 146             | 93               | (160)                                     | 319               | 159              |
| Federal funds sold and securities purchased under agreements to resell | (8)   |                 | (8)              | 5   |                   | 5                |
| Interest-bearing deposits in other financial institutions              | 55  | (10)            | 45               | 258                                       | (13)              | 245              |
| Other  | 5   | 21              | 26               | 83  | 179               | 262              |
| <b>Total interest income (2)</b>                                       | <b>21,815</b>                               | <b>80</b>       | <b>21,895</b>    | <b>42,936</b>                             | <b>(8,891)</b>    | <b>34,045</b>    |
| <b>Interest expense</b>  |   |                 |                  |   |                   |                  |
| Deposits   | \$ 1,159                                    | \$ (1,431)      | \$ (272)         | \$ 2,605                                  | \$ (2,524)        | \$ 81            |
| Notes payable and other borrowings                                     | 42  | (26)            | 16               | 36  | (48)              | (12)             |
| <b>Total interest expense</b>  | <b>1,201</b>                                | <b>(1,457)</b>  | <b>(256)</b>     | <b>2,641</b>                              | <b>(2,572)</b>    | <b>69</b>        |
| <b>Net interest income (2)</b>   | <b>\$ 20,614</b>                            | <b>\$ 1,537</b> | <b>\$ 22,151</b> | <b>\$ 40,295</b>                          | <b>\$ (6,319)</b> | <b>\$ 33,976</b> |

(1) Changes attributable to both volume and yield/rate are included in yield/rate column.

(2) Annualized taxable equivalent.

Taxable equivalent net interest income increased \$22.2 million and \$34.0 million during the three and six months ended June 30, 2014, respectively, compared with the same periods in 2013. Increases in the volume of interest-earning assets, primarily loans acquired in the FNB Transaction, increased taxable equivalent net interest income by \$21.8 million and \$42.9 million during the three and six months ended June 30, 2014, respectively, compared with the same periods in 2013, while increases in the volume of interest-bearing liabilities, primarily deposits assumed in the FNB Transaction, reduced taxable equivalent interest income by \$1.2 million and \$2.6 million during these same respective periods. Increases in accretable yields on loans, particularly accretable yield on loans acquired in the PlainsCapital Merger, as well as increased yields on the investment portfolio, were offset by a lower yield on subsidiary warehouse lines of credit, resulting in a net minimal effect on taxable equivalent net interest income due to yield on interest-earning assets for the three months ended June 30, 2014, compared to the same period in 2013. Changes in the yields earned on interest-earning assets decreased taxable equivalent net interest income by \$8.9 million during the six months ended June 30, 2014, compared with the same period in 2013, primarily due to lower yields on the loan portfolio and the subsidiary warehouse lines of credit. Changes in rates paid on interest-bearing liabilities increased taxable equivalent interest income by \$1.5 million and \$2.6 million during the three and six months ended June 30, 2014, respectively, compared with the same periods in 2013, primarily due to the amortization of premiums on time deposits acquired in the FNB Transaction.

The banking segment's noninterest income was \$16.4 million and \$11.9 million during the three months ended June 30, 2014 and 2013, respectively, and \$32.6 million and \$24.1 million during the six months ended June 30, 2014 and 2013, respectively. These year-over-year increases in noninterest income were primarily due to service charges and fees on deposits assumed in the FNB Transaction, as well as accretion

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on the amounts receivable under the loss-share agreements with the FDIC ( FDIC Indemnification Asset ) associated with the FNB Transaction. Noninterest income was also negatively affected by decreases in intercompany financing charges associated with the lending commitment on the PrimeLending warehouse line of credit.

The banking segment's noninterest expenses were \$60.2 million and \$31.9 million during the three months ended June 30, 2014 and 2013, respectively, and \$120.9 million and \$62.6 million during the six months ended June 30, 2014 and 2013, respectively. Noninterest expenses were primarily comprised of employees' compensation and benefits, and occupancy expenses. The significant year-over-year increase in noninterest expenses was primarily due to the inclusion of the operations acquired in the FNB Transaction.

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**Mortgage Origination Segment**

Income before income taxes in our mortgage origination segment for the three months ended June 30, 2014 and 2013 was \$9.2 million and \$18.9 million, respectively, while income before income taxes in our mortgage origination segment for the six months ended June 30, 2014 and 2013 was \$6.2 million and \$31.2 million, respectively. These decreases in income before income taxes for the three and six months ended June 30, 2014 compared to the same periods in 2013 were primarily due to the decreases in noninterest income driven by the reduction in loan origination volume, partially offset by the decreases in noninterest expense primarily due to the reductions in compensation expense that varies with the volume of mortgage loan originations, and to a lesser extent, reductions in segment operating costs made to address the reduction in loan origination volume. Additionally, net interest expense of \$2.4 million and \$11.8 million during the three months ended June 30, 2014 and 2013, respectively, and net interest expense of \$6.5 million and \$23.9 million during the six months ended June 30, 2014 and 2013, respectively, resulted from interest incurred on a warehouse line of credit held at the Bank as well as related intercompany financing costs, partially offset by interest income earned on loans held for sale.

The mortgage origination segment originates all of its mortgage loans through a retail channel. The following table provides certain details regarding our mortgage loan originations (dollars in thousands).

|                                     | Three Months Ended June 30, |            |              |            | Six Months Ended June 30, |            |              |            |
|-------------------------------------|-----------------------------|------------|--------------|------------|---------------------------|------------|--------------|------------|
|                                     | 2014                        | % of Total | 2013         | % of Total | 2014                      | % of Total | 2013         | % of Total |
| Mortgage Loan Originations - units  | 13,373                      |            | 16,508       |            | 22,525                    |            | 30,954       |            |
| Mortgage Loan Originations - volume | \$ 2,838,731                |            | \$ 3,549,670 |            | \$ 4,704,884              |            | \$ 6,595,933 |            |
| Mortgage Loan Originations:         |                             |            |              |            |                           |            |              |            |
| Conventional                        | \$ 1,777,589                | 62.62%     | \$ 2,251,378 | 63.43%     | \$ 2,971,726              | 63.16%     | \$ 4,176,149 | 63.31%     |
| Government                          | 818,158                     | 28.82%     | 1,022,069    | 28.79%     | 1,370,486                 | 29.13%     | 1,945,788    | 29.50%     |
| Jumbo                               | 238,991                     | 8.42%      | 267,063      | 7.52%      | 355,725                   | 7.56%      | 452,451      | 6.86%      |
| Other                               | 3,993                       | 0.14%      | 9,160        | 0.26%      | 6,947                     | 0.15%      | 21,545       | 0.33%      |
|                                     | \$ 2,838,731                | 100.00%    | \$ 3,549,670 | 100.00%    | \$ 4,704,884              | 100.00%    | \$ 6,595,933 | 100.00%    |
| Home purchases                      | \$ 2,396,094                | 84.41%     | \$ 2,377,871 | 66.99%     | \$ 3,864,805              | 82.14%     | \$ 3,987,732 | 60.46%     |
| Refinancings                        | 442,637                     | 15.59%     | 1,171,799    | 33.01%     | 840,079                   | 17.86%     | 2,608,201    | 39.54%     |
|                                     | \$ 2,838,731                | 100.00%    | \$ 3,549,670 | 100.00%    | \$ 4,704,884              | 100.00%    | \$ 6,595,933 | 100.00%    |
| Texas                               | \$ 692,878                  | 24.41%     | \$ 788,996   | 22.23%     | \$ 1,123,033              | 23.87%     | \$ 1,446,257 | 21.93%     |
| California                          | 387,445                     | 13.65%     | 673,388      | 18.97%     | 679,017                   | 14.43%     | 1,225,206    | 18.57%     |
| Florida                             | 135,701                     | 4.78%      | 116,419      | 3.28%      | 229,075                   | 4.87%      | 226,592      | 3.43%      |
| North Carolina                      | 123,930                     | 4.37%      | 181,365      | 5.11%      | 215,662                   | 4.58%      | 356,206      | 5.40%      |
| Ohio                                | 117,026                     | 4.12%      | 121,378      | 3.42%      | 184,106                   | 3.91%      | 230,734      | 3.50%      |
| Virginia                            | 93,538                      | 3.29%      | 149,027      | 4.20%      | 144,417                   | 3.07%      | 281,514      | 4.27%      |
| Arizona                             | 85,268                      | 3.00%      | 123,473      | 3.48%      | 164,753                   | 3.50%      | 230,734      | 3.50%      |
| Missouri                            | 84,962                      | 2.99%      | 56,728       | 1.60%      | 137,209                   | 2.92%      | 102,343      | 1.55%      |
| South Carolina                      | 84,190                      | 2.97%      | 96,326       | 2.71%      | 130,107                   | 2.77%      | 172,104      | 2.61%      |
| All other states                    | 1,033,793                   | 36.42%     | 1,242,570    | 35.00%     | 1,697,505                 | 36.08%     | 2,324,243    | 35.24%     |
|                                     | \$ 2,838,731                | 100.00%    | \$ 3,549,670 | 100.00%    | \$ 4,704,884              | 100.00%    | \$ 6,595,933 | 100.00%    |

The mortgage lending business is subject to variables that can impact loan origination volume, including seasonal and interest rate fluctuations. Historically, we have typically experienced increased loan origination volume from purchases of homes during the spring and summer, when

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more people tend to move and buy or sell homes. An increase in mortgage interest rates tends to result in decreased loan origination volume from refinancings, while a decrease in mortgage interest rates tends to result in increased refinancings. Changes in interest rates have historically had a lesser impact on home purchases volume than on refinancing volume.

Beginning in May 2013 and continuing through the fourth quarter of 2013, mortgage interest rates increased at a pace that, along with other factors, resulted in decreases of 20.0% and 28.7% in the mortgage origination segment's total loan origination volume during the three and six months ended June 30, 2014 when compared to the same periods in 2013. Home purchases volume of \$2.4 billion during the three months ended June 30, 2014 was virtually unchanged from the three months ended June 30, 2013, while the mortgage origination segment experienced a \$927.4 million increase, or 63.1%, in home purchases volume between the three months ended March 31, 2014 and three months ended June 30, 2014. Refinancing volume decreased from \$1.2 billion during the three months ended June 30, 2013 (33% of total loan origination volume) to \$442.6 million during the three months ended June 30, 2014 (16% of total loan origination volume). For each

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quarter subsequent to the second quarter of 2013, the mortgage origination segment's refinancing volume as a percentage of total loan origination volume has ranged between 16% and 21%. We anticipate that this trend will continue throughout the remainder of 2014, and total mortgage loan origination volumes in 2014 will more closely follow seasonal trends historically experienced by the mortgage origination segment.

While the mortgage origination segment's total loan origination volume decreased 20.0% during the three months ended June 30, 2014, compared to the same period in 2013, income before income taxes decreased 51.3% between the same periods (\$9.2 million income compared to \$18.9 million income). Income before income taxes decreased at a greater rate primarily because segment operating costs included in noninterest expenses, such as employee related (salaries and benefits), occupancy, and administrative expenses, decreased at a lesser rate, approximately 11%, than loan origination volume decreased between the two periods. To address negative trends in loan origination volume resulting from changes in interest rates that began in May 2013, the mortgage origination segment reduced its non-origination employee headcount approximately 22% during the third and fourth quarters of 2013. Salaries and benefits expenses for the three and six months ended June 30, 2014 decreased approximately 11% and 13% respectively, as compared to the same periods in 2013 as the benefits of the headcount reductions in the third and fourth quarters of 2013 were realized. We also engaged in other initiatives to reduce segment operating costs during the third and fourth quarters of 2013 that were primarily responsible for the decrease of approximately 11% in non-employee related expenses for both the three and six months ended June 30, 2014 as compared to the same periods in 2013. The benefits of the employee reductions and other cost savings initiatives include a decrease in recurring quarterly operating costs of approximately \$8 million since the third quarter of 2013. Also impacting the trend in income before taxes, to a lesser extent, was a decrease in loan revenue margins resulting from increased pricing competition.

The mortgage origination segment sells substantially all mortgage loans it originates to various investors in the secondary market, the majority servicing released. During the six months ended June 30, 2013, the mortgage origination segment retained servicing on approximately 8% of loans sold. This rate was increased to approximately 22% during the third and fourth quarters of 2013, and approximately 31% during the six months ended June 30, 2014. The related mortgage servicing rights (MSR) asset was valued at \$35.9 million on \$3.3 billion of serviced loan volume at June 30, 2014, compared to a value of \$20.1 million on \$2.0 billion of serviced loan volume at December 31, 2013. All income related to retained servicing, including changes in the value of the MSR asset, is included in noninterest income. The mortgage origination segment's determination on whether to retain or release servicing on mortgage loans it sells is impacted by changes in mortgage interest rates, and refinancing and market activity. We may, from time to time, manage our MSR asset through different strategies, including varying the percentage of mortgage loans sold servicing released and opportunistically selling MSR assets. In July 2014, the mortgage origination segment sold MSR assets of \$11.4 million, which represented approximately \$1.0 billion of its serviced loan volume.

Noninterest income was \$122.8 million and \$165.3 million for the three months ended June 30, 2014 and 2013, respectively, and \$214.6 million and \$311.8 million for the six months ended June 30, 2014 and 2013, respectively. Noninterest income was comprised of net gains on the sale of loans and other mortgage production income, and mortgage origination fees. Noninterest income decreased 25.7% and 31.2% during the three and six months ended June 30, 2014 when compared to the same periods in 2013, which were comparable to the decreases of 20.0% and 28.7% in loan origination volume experienced during the same respective periods.

Gains and losses resulting from changes in the fair value of the mortgage origination segment's interest rate lock commitments (IRLCs) and loans held for sale, and the related activity associated with forward commitments used by the mortgage origination segment to mitigate interest rate risk associated with its IRLCs and mortgage loans held for sale, are included in noninterest income. Related net gains totaled \$25.7 million and \$6.9 million during the three months ended June 30, 2014 and 2013, respectively, and net gains totaled \$29.0 million and \$3.4 million during the six months ended June 30, 2014 and 2013, respectively. During the three and six months ended June 30, 2014, the net gains were primarily the result of an increase in the volume of IRLCs and mortgage loans held during these respective periods.



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Noninterest expenses were \$111.2 million and \$134.5 million for the three months ended June 30, 2014 and 2013, respectively, and \$201.9 million and \$256.8 million for the six months ended June 30, 2014 and 2013, respectively. Employees' compensation and benefits accounted for the majority of the noninterest expenses incurred. Compensation that varies with the volume of mortgage loan originations and overall segment profitability decreased \$14.1 million and \$31.4 million during the three and six months ended June 30, 2014, as compared to the same periods in 2013, and comprised

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approximately 60% and 64% of the total employees' compensation and benefits expenses during the three months ended June 30, 2014 and 2013, respectively, and 56% and 62% during the six months ended June 30, 2014 and 2013, respectively. In addition, employee salaries and benefits decreased \$3.7 million and \$8.5 million during the three and six months ended June 30, 2014, as compared to the same periods in 2013, primarily as a result of headcount reductions in the third and fourth quarters of 2013. The mortgage origination segment records unreimbursed closing costs as noninterest expense when it pays a customer's closing costs in return for the customer choosing to accept a higher interest rate on the customer's mortgage loan. Unreimbursed closing costs during the three months ended June 30, 2014 and 2013 were \$8.7 million and \$9.8 million, respectively, and \$13.9 million and \$20.3 million for the six months ended June 30, 2014 and 2013, respectively.

Between January 1, 2005, and June 30, 2014, the mortgage origination segment sold mortgage loans totaling \$59.9 billion. These loans were sold under sales contracts that generally include provisions which hold the mortgage origination segment responsible for errors or omissions relating to its representations and warranties that loans sold meet certain requirements, including representations as to underwriting standards and the validity of certain borrower representations in connection with the loan. In addition, the sales contracts typically require the refund of purchased servicing rights plus certain investor servicing costs if a loan experiences an early payment default. While the mortgage origination segment sold loans prior to 2005, it has not experienced, nor does it anticipate experiencing, significant losses on loans originated prior to 2005 as a result of investor claims under these provisions of its sales contracts.

When an investor claim for indemnification of a loan sold is made, we evaluate the claim and determine if the claim can be satisfied through additional documentation or other deliverables. If the claim cannot be satisfied in that matter, we negotiate with the investor to reach a settlement of the claim. Settlements typically result in either the repurchase of a loan or reimbursement to the investor for losses incurred on the loan. Following is a summary of the mortgage origination segment's claims resolution activity relating to loans sold between January 1, 2005 and June 30, 2014 (dollars in thousands).

|  | Original Loan Balance |                 | Loss Recognized |                 |
|--|-----------------------|-----------------|-----------------|-----------------|
|  | Amount                | % of Loans Sold | Amount          | % of Loans Sold |
| Claims resolved with no payment  | \$ 145,524            | 0.24%           | \$              | 0.00%           |
| Claims resolved as a result of a loan repurchase or payment to an investor for losses incurred (1) | 185,178               | 0.31%           | 24,291          | 0.04%           |
|  | \$ 330,702            | 0.55%           | \$ 24,291       | 0.04%           |

(1) Losses incurred include refunded purchased servicing rights.

At June 30, 2014 and December 31, 2013, the mortgage origination segment's indemnification liability reserve totaled \$19.7 million and \$21.1 million, respectively. The related provision for indemnification losses was \$0.9 million and \$1.0 million for the three months ended June 30, 2014 and 2013, respectively, and \$1.4 million and \$2.0 million for the six months ended June 30, 2014 and 2013, respectively.

**Insurance Segment**

Losses before income taxes in our insurance segment were \$5.5 million and \$20.5 million during the three months ended June 30, 2014 and 2013. Income before income taxes in our insurance segment was \$6.0 million during the six months ended June 30, 2014, compared with a loss

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before income taxes of \$14.3 million during the same period in 2013. The insurance segment is subject to claims arising out of severe weather, the incidence and severity of which are inherently unpredictable. Generally, the insurance segment's insured risks exhibit higher losses in the second and third calendar quarters due to a seasonal concentration of weather-related events in its primary geographic markets. Although weather-related losses (including hail, high winds, tornadoes and hurricanes) can occur in any calendar quarter, the second calendar quarter, historically, has experienced the highest frequency of losses associated with these events. Hurricanes, however, are more likely to occur in the third calendar quarter of the year.

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The significant year-over-year improvements in operating results in our insurance segment were primarily a result of growth of earned premium and improved claims loss experience associated with the significant decline in the severity of severe weather-related events during 2014. Based on our estimates of the ultimate losses, claims associated with these storms totaled \$14.3 million through June 30, 2014. The significant loss during the three months ended June 30, 2013 was primarily driven by the severity of three tornado, wind and hail storms during the second quarter of 2013. Based on estimates of the ultimate cost, two of these storms are considered catastrophic losses as they exceeded our \$8 million reinsurance retention during the third quarter of 2013. The estimate of ultimate losses from these storms totaled \$20.9 million through June 30, 2013 with a net loss, after reinsurance, of \$20.7 million.

During 2013, the insurance segment initiated a review of the pricing of its primary products in each state of operation utilizing a consulting actuarial firm to supplement normal review processes. Rate filings have been made for certain products in several states for increases effective in 2014, and the process will continue through the remainder of the insurance segment's products and states in which it operates. Concurrently, business concentrations were reviewed and actions initiated, including cancellation of agents, non-renewal of policies and cessation of new business writing on certain products in problematic geographic areas. These actions have reduced the rate of premium growth for the first six months of 2014 when compared with the patterns exhibited in prior years. However, we expect the reduced exposure to volatile weather through a lower number of insureds in these areas to improve our loss experience during 2014.

The insurance segment's operations resulted in combined ratios of 118.2% and 158.2% during the three months ended June 30, 2014 and 2013, respectively, and 97.9% and 124.0% during the six months ended June 30, 2014 and 2013, respectively. The year-over-year improvement in the combined ratios was primarily driven by the increase in earned premiums and improvement in our claims loss experience. The combined ratio is a measure of overall insurance underwriting profitability, and represents the sum of the loss and LAE ratio and the underwriting expense ratio, which are discussed in more detail below.

Noninterest income of \$43.1 million during the three months ended June 30, 2014 included net insurance premiums earned of \$40.8 million, compared to \$38.6 million for the same period in 2013, while noninterest income of \$85.9 million during the six months ended June 30, 2014 included net insurance premiums earned of \$81.1 million, compared to \$76.1 million for the same period in 2013. The increase in earned premiums during both periods is primarily attributable to rate and volume increases in homeowners and mobile home products.

Direct insurance premiums written by major product line are presented in the table below (in thousands).

|                                  | Three Months Ended June 30, |           | Variance     | Six Months Ended June 30, |           | Variance     |
|----------------------------------|-----------------------------|-----------|--------------|---------------------------|-----------|--------------|
|                                  | 2014                        | 2013      | 2014 vs 2013 | 2014                      | 2013      | 2014 vs 2013 |
| <b>Direct Insurance Premiums</b> |                             |           |              |                           |           |              |
| <b>Written:</b>                  |                             |           |              |                           |           |              |
| Homeowners                       | \$ 21,431                   | \$ 21,980 | \$ (549)     | \$ 40,016                 | \$ 40,524 | \$ (508)     |
| Fire                             | 15,125                      | 14,959    | 166          | 28,960                    | 28,011    | 949          |
| Mobile Home                      | 10,280                      | 9,646     | 634          | 20,499                    | 18,729    | 1,770        |
| Commercial                       | 1,075                       | 1,264     | (189)        | 2,161                     | 2,398     | (237)        |
| Other                            | 88                          | 101       | (13)         | 134                       | 145       | (11)         |
|                                  | \$ 47,999                   | \$ 47,950 | \$ 49        | \$ 91,770                 | \$ 89,807 | \$ 1,963     |

Total direct insurance premiums written for our three largest insurance product lines increased by \$0.3 million and \$2.2 million during the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013. These increases were due to growth in our core insurance products.

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Net insurance premiums earned by major product line are presented in the table below (in thousands).

|                                       | Three Months Ended June 30, |           | Variance     | Six Months Ended June 30, |           | Variance     |
|---------------------------------------|-----------------------------|-----------|--------------|---------------------------|-----------|--------------|
|                                       | 2014                        | 2013      | 2014 vs 2013 | 2014                      | 2013      | 2014 vs 2013 |
| <b>Net Insurance Premiums Earned:</b> |                             |           |              |                           |           |              |
| Homeowners                            | \$ 18,243                   | \$ 17,721 | \$ 522       | \$ 35,361                 | \$ 34,322 | \$ 1,039     |
| Fire                                  | 12,847                      | 12,039    | 808          | 25,592                    | 23,724    | 1,868        |
| Mobile Home                           | 8,701                       | 7,730     | 971          | 18,114                    | 15,862    | 2,252        |
| Commercial                            | 909                         | 1,015     | (106)        | 1,910                     | 2,031     | (121)        |
| Other                                 | 77                          | 85        | (8)          | 119                       | 124       | (5)          |
|                                       | \$ 40,777                   | \$ 38,590 | \$ 2,187     | \$ 81,096                 | \$ 76,063 | \$ 5,033     |

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Net insurance premiums earned for the three and six months ended June 30, 2014 increased compared to the same periods in 2013, primarily due to increases in net insurance premiums written of \$0.5 million and \$3.3 million, respectively.

Noninterest expenses of \$49.4 million and \$62.1 million during the three months ended June 30, 2014 and 2013, respectively, and \$81.8 million and \$96.4 million during the six months ended June 30, 2014 and 2013, respectively, include both loss and LAE expenses and policy acquisition and other underwriting expenses, as well as other noninterest expenses. Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. Loss and LAE during the three months ended June 30, 2014 was \$35.3 million, compared to \$48.2 million during the same period in 2013, resulting in loss and LAE ratios of 86.5% and 124.8% during the three months ended June 30, 2014 and 2013, respectively. Loss and LAE during the six months ended June 30, 2014 was \$53.6 million, compared to \$69.3 million during the same period in 2013. As a result, the loss and LAE ratios during the six months ended June 30, 2014 and 2013 were 66.1% and 91.2%, respectively. These year-over-year ratio improvements were primarily a result of growth of earned premium and improved claims loss experience associated with the significant decline in the severity of severe weather-related events during 2014.

Policy acquisition and other underwriting expenses encompass all expenses incurred relative to NLC operations, and include elements of multiple categories of expense otherwise reported as noninterest expense in the consolidated statements of operations.

Policy acquisition and other underwriting expenses were as follows (dollars in thousands).

|                                   | Three Months Ended June 30, |                  | Variance     | Six Months Ended June 30, |                  | Variance      |
|-----------------------------------|-----------------------------|------------------|--------------|---------------------------|------------------|---------------|
|                                   | 2014                        | 2013             | 2014 vs 2013 | 2014                      | 2013             | 2014 vs 2013  |
| Amortization of deferred          |                             |                  |              |                           |                  |               |
| policy acquisition costs          | \$ 10,402                   | \$ 10,273        | \$ 129       | \$ 20,599                 | \$ 19,887        | \$ 712        |
| Other underwriting expenses       | 3,325                       | 3,273            | 52           | 6,705                     | 6,304            | 401           |
| <b>Total</b>                      | <b>13,727</b>               | <b>13,546</b>    | <b>181</b>   | <b>27,304</b>             | <b>26,191</b>    | <b>1,113</b>  |
| Agency expenses                   | (813)                       | (658)            | (155)        | (1,503)                   | (1,226)          | (277)         |
| <b>Total less agency expenses</b> | <b>\$ 12,914</b>            | <b>\$ 12,888</b> | <b>\$ 26</b> | <b>\$ 25,801</b>          | <b>\$ 24,965</b> | <b>\$ 836</b> |
| Net insurance premiums            |                             |                  |              |                           |                  |               |
| earned                            | \$ 40,777                   | \$ 38,590        | \$ 2,187     | \$ 81,096                 | \$ 76,063        | \$ 5,033      |
| <b>Expense ratio</b>              | <b>31.7%</b>                | <b>33.4%</b>     | <b>-1.7%</b> | <b>31.8%</b>              | <b>32.8%</b>     | <b>-1.0%</b>  |

### **Financial Advisory Segment**

Income before income taxes in our financial advisory segment during the three months ended June 30, 2014 and 2013 was \$0.6 million and \$2.0 million, respectively, while income before income taxes in our financial advisory segment during the six months ended June 30, 2014 and 2013 was \$0.5 million and \$2.3 million, respectively. Continuing uncertainty in fixed income markets as a result of increased regulations, uncertainty in the direction of future interest rates and a lack of liquidity in the market have resulted in reduced sales of fixed income securities to institutional customers.

The financial advisory segment had net interest income of \$3.2 million and \$3.5 million during the three months ended June 30, 2014 and 2013, respectively, and \$5.8 million and \$6.8 million during the six months ended June 30, 2014 and 2013, respectively, consisting of securities

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lending activity, customer margin loan balances and investment securities used to support sales, underwriting and other customer activities.

Noninterest income was \$25.8 million and \$28.9 million during the three months ended June 30, 2014 and 2013, respectively, and \$50.4 million and \$51.6 million during the six months ended June 30, 2014 and 2013, respectively. The majority of the financial advisory segment's noninterest income was generated from fees and commissions earned from investment advisory and securities brokerage activities of \$22.3 million and \$26.0 million during the three months ended June 30, 2014 and 2013, respectively, and \$43.6 million and \$48.0 million during the six months ended June 30, 2014 and 2013, respectively. The financial advisory segment participates in programs in which it issues forward purchase commitments of mortgage-backed securities to certain clients and sells TBAs. Changes in the fair values of these derivative instruments produced net gains of \$3.2 million and \$3.8 million during the three months ended June 30, 2014 and 2013, respectively, and \$6.1 million and \$5.6 million during the six months ended June 30, 2014 and 2013, respectively. Changes in the fair value of the financial advisory segment's trading portfolio, which is used to support sales, underwriting and other customer activities, produced gains of \$0.3 million and losses of \$1.9 million during the three months ended June 30, 2014 and 2013, respectively, and gains of \$0.7 million and losses of \$0.9 million during the six months ended June 30, 2014 and 2013, respectively.

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Noninterest expenses were \$28.4 million and \$30.4 million during the three months ended June 30, 2014 and 2013, respectively, and \$55.7 million and \$56.1 million during the six months ended June 30, 2014 and 2013, respectively. Employees' compensation and benefits accounted for the majority of the decrease in noninterest expenses primarily due to decreases in compensation costs that vary with noninterest income.

**Corporate**

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

As a holding company, Hilltop's primary investment objectives are to preserve capital and have available cash resources to utilize in making acquisitions. Investment and interest income earned, primarily from available cash and available-for-sale securities, including our note receivable from SWS, was \$1.7 million and \$1.6 million during the three months ended June 30, 2014 and 2013, respectively, and \$3.4 million and \$3.3 million during the six months ended June 30, 2014 and 2013, respectively.

Interest expense of \$1.7 million and \$3.5 million during the three and six months ended June 30, 2013, respectively, was due to interest costs associated with the 7.50% Senior Exchangeable Notes due 2025 of HTH Operating Partnership LP, a wholly owned subsidiary of Hilltop, which were called for redemption during the fourth quarter of 2013.

Noninterest expenses were \$2.6 million and \$1.7 million during the three months ended June 30, 2014 and 2013, respectively, and \$4.8 million and \$3.9 million during the six months ended June 30, 2014 and 2013, respectively. Noninterest expenses were primarily comprised of employees' compensation and benefits and professional fees. The increases in noninterest expenses were primarily due to year-over-year increases in headcount and related costs.

***Financial Condition***

The following discussion contains a more detailed analysis of our financial condition at June 30, 2014 as compared to December 31, 2013.

**Securities Portfolio**

At June 30, 2014, investment securities consisted of securities of the U.S. Treasury, U.S. government and its agencies, obligations of municipalities and other political subdivisions, primarily in the State of Texas, mortgage-backed, corporate debt, and equity securities, a note receivable and a warrant. We have the ability to categorize investments as trading, available for sale, and held to maturity.



Trading securities are bought and held principally for the purpose of selling them in the near term and are carried at fair value, marked to market through operations and held at the Bank and First Southwest. Securities that may be sold in response to changes in market interest rates, changes in securities prepayment risk, increases in loan demand, general liquidity needs and other similar factors are classified as available for sale and are carried at estimated fair value, with unrealized gains and losses recorded in accumulated other comprehensive income (loss). Securities are classified as held to maturity based on the intent and ability of our management, at the time of purchase, to hold such securities to maturity. These securities are carried at amortized cost.

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The table below summarizes our securities portfolio (in thousands).

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| <b>Trading securities, at fair value</b>              | \$ 61,663        | \$ 58,846            |
| <b>Securities available for sale, at fair value</b>   |                  |                      |
| U.S. Treasury securities                              | 63,822           | 43,528               |
| U.S. government agencies:                             |                  |                      |
| Bonds   | 635,099          | 662,732              |
| Residential mortgage-backed securities                | 57,504           | 60,087               |
| Collateralized mortgage obligations                   | 107,130          | 120,461              |
| Corporate debt securities                             | 101,255          | 76,608               |
| States and political subdivisions                     | 147,831          | 156,835              |
| Commercial mortgage-backed securities                 | 665              | 760                  |
| Equity securities                                     | 24,653           | 22,079               |
| Note receivable                                       | 49,921           | 47,909               |
| Warrant   | 13,898           | 12,144               |
|   | 1,201,778        | 1,203,143            |
| <b>Securities held to maturity, at amortized cost</b> |                  |                      |
| U.S. government agencies:                             |                  |                      |
| Residential mortgage-backed securities                | 31,048           |                      |
| Collateralized mortgage obligations                   | 29,821           |                      |
| States and political subdivisions                     | 4,406            |                      |
|   | 65,275           |                      |
| <b>Total securities portfolio</b>                     | \$ 1,328,716     | \$ 1,261,989         |

We had net unrealized losses of \$4.1 million and \$53.7 million related to the available for sale investment portfolio at June 30, 2014 and December 31, 2013, respectively. The significant decrease in the net unrealized loss position of our available for sale investment portfolio during 2014 was due to the effects of a decrease in market interest rates since December 31, 2013 that resulted in an increase in the fair value of our debt securities.

The market value of securities held to maturity at June 30, 2014 approximated book value.

*Banking Segment*

The banking segment's securities portfolio plays a role in the management of our interest rate sensitivity and generates additional interest income. In addition, the securities portfolio is used to meet collateral requirements for public and trust deposits, securities sold under agreements to repurchase and other purposes. The available for sale securities portfolio serves as a source of liquidity. Historically, the Bank's policy has been to invest primarily in securities of the U.S. government and its agencies, obligations of municipalities in the State of Texas and other high grade fixed income securities to minimize credit risk. At June 30, 2014, the banking segment's securities portfolio of \$1.1 billion was comprised of trading securities of \$21.1 million, available for sale securities of \$974.1 million and held to maturity securities of \$65.3 million.

*Insurance Segment*

Our insurance segment's primary investment objective is to preserve capital and manage for a total rate of return. NLC's strategy is to purchase securities in sectors that represent the most attractive relative value. Our insurance segment invests the premiums it receives from policyholders until they are needed to pay policyholder claims or other expenses. At June 30, 2014, the insurance segment's securities portfolio was comprised of \$153.1 million in available for sale securities and \$5.5 million of other investments included in other assets within the consolidated balance sheet.

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Our financial advisory segment holds securities to support sales, underwriting and other customer activities. Because FSC is a broker-dealer, it is required to carry its securities at fair value and record changes in the fair value of the portfolio in operations. Accordingly, FSC classifies its securities portfolio of \$40.5 million at June 30, 2014 as trading.

*Corporate*

Available for sale securities of Hilltop at June 30, 2014 include the note receivable from, and warrant to purchase shares of SWS, of \$63.8 million, and equity securities of \$10.7 million representing those shares of SWS common stock held by Hilltop.

**Non-Covered Loan Portfolio**

Consolidated non-covered loans held for investment are detailed in the table below, classified by portfolio segment and segregated between those considered to be PCI loans and all other originated or acquired loans (in thousands). PCI loans showed evidence of credit deterioration that makes it probable that all contractually required principal and interest payments will not be collected.

|  | Loans, excluding<br>PCI Loans | PCI<br>Loans | Total<br>Loans |
|--|-------------------------------|--------------|----------------|
| <b>June 30, 2014</b>                   |                               |              |                |
| Commercial and industrial              | \$ 1,660,181                  | \$ 21,474    | \$ 1,681,655   |
| Real estate                            | 1,560,314                     | 26,221       | 1,586,535      |
| Construction and land<br>development   | 381,608                       | 10,003       | 391,611        |
| Consumer                               | 51,947                        | 3,089        | 55,036         |
| Non-covered loans, gross               | 3,654,050                     | 60,787       | 3,714,837      |
| Allowance for loan losses              | (32,857)                      | (3,574)      | (36,431)       |
| Non-covered loans, net of<br>allowance | \$ 3,621,193                  | \$ 57,213    | \$ 3,678,406   |

|                                      | Loans, excluding<br>PCI Loans | PCI<br>Loans | Total<br>Loans |
|--------------------------------------|-------------------------------|--------------|----------------|
| <b>December 31, 2013</b>             |                               |              |                |
| Commercial and industrial            | \$ 1,600,450                  | \$ 36,816    | \$ 1,637,266   |
| Real estate                          | 1,418,003                     | 39,250       | 1,457,253      |
| Construction and land<br>development | 344,734                       | 19,817       | 364,551        |
| Consumer                             | 51,067                        | 4,509        | 55,576         |
| Non-covered loans, gross             | 3,414,254                     | 100,392      | 3,514,646      |
| Allowance for loan losses            | (30,104)                      | (3,137)      | (33,241)       |
|                                      | \$ 3,384,150                  | \$ 97,255    | \$ 3,481,405   |

Non-covered loans, net of allowance

*Banking Segment*

The loan portfolio constitutes the major earning asset of the banking segment and typically offers the best alternative for obtaining the maximum interest spread above the banking segment's cost of funds. The overall economic strength of the banking segment generally parallels the quality and yield of its loan portfolio. The banking segment's loan portfolio is presented below in two sections, Non-Covered Loan Portfolio and Covered Loan Portfolio. The Covered Loan Portfolio consists of loans acquired in the FNB Transaction that are subject to loss-share agreements with the FDIC and is discussed below. The Non-Covered Loan Portfolio includes all other loans held by the Bank, which we refer to as non-covered loans, and is discussed herein.

The banking segment's total non-covered loans, net of the allowance for non-covered loan losses, were \$4.2 billion and \$4.3 billion at June 30, 2014 and December 31, 2013, respectively. The banking segment's non-covered loan portfolio includes a \$1.5 billion warehouse line of credit extended to PrimeLending, of which \$1.3 billion and \$1.0 billion was drawn at June 30, 2014 and December 31, 2013, respectively, as well as term loans to First Southwest that had an outstanding balance of \$23.0 million at June 30, 2014 and December 31, 2013. Prior to June 2014, the warehouse line of credit had \$1.3 billion of availability. Amounts advanced against the warehouse line of credit and the First Southwest term loans are eliminated from net loans on our consolidated balance sheets.

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The banking segment does not generally participate in syndicated loan transactions and has no foreign loans in its portfolio. The areas of concentration within our covered real estate portfolio were construction and land development loans, non-construction residential real estate loans, and non-construction commercial real estate loans. At June 30, 2014, the banking segment's non-covered loan concentrations (loans to borrowers engaged in similar activities) that exceeded 10% of its total non-covered loans included construction and land development loans and non-construction commercial real estate loans within the non-covered real estate portfolio. At June 30, 2014, construction and land development loans and non-construction commercial real estate loans were 10.39% and 29.40%, respectively, of the banking segment's total non-covered loans. The banking segment's non-covered loan concentrations were within regulatory guidelines at June 30, 2014.

*Mortgage Origination Segment*

The loan portfolio of the mortgage origination segment consists of loans held for sale, primarily single-family residential mortgages funded through PrimeLending, and pipeline loans, which are loans in various stages of the application process, but not yet closed and funded. Pipeline loans may not close if potential borrowers elect in their sole discretion not to proceed with the loan application. Total loans held for sale were \$1.4 billion and \$1.1 billion at June 30, 2014 and December 31, 2013, respectively.

The components of the mortgage origination segment's loans held for sale and pipeline loans are as follows (in thousands).

|                             | <b>June 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|-----------------------------|--------------------------|------------------------------|
| <b>Loans held for sale:</b> |                          |                              |
| Unpaid principal balance    | \$ 1,348,551             | \$ 1,066,850                 |
| Fair value adjustment       | 61,723                   | 21,555                       |
|                             | \$ 1,410,274             | \$ 1,088,405                 |
| <b>Pipeline loans:</b>      |                          |                              |
| Unpaid principal balance    | \$ 981,330               | \$ 602,467                   |
| Fair value adjustment       | 28,584                   | 12,151                       |
|                             | \$ 1,009,914             | \$ 614,618                   |

*Financial Advisory Segment*

The loan portfolio of the financial advisory segment consists primarily of margin loans to customers and correspondents. These loans are collateralized by the securities purchased or by other securities owned by the clients and, because of collateral coverage ratios, are believed to present minimal collectability exposure. Additionally, these loans are subject to a number of regulatory requirements as well as FSC's internal policies. The financial advisory segment's total non-covered loans, net of the allowance for non-covered loan losses, were \$356.7 million and \$281.6 million at June 30, 2014 and December 31, 2013, respectively. This increase was primarily attributable to increased borrowings in margin accounts held by FSC customers and correspondents.

**Covered Loan Portfolio**

*Banking Segment*

Loans acquired in the FNB Transaction that are subject to loss-share agreements with the FDIC are referred to as covered loans and reported separately in our consolidated balance sheets. Under the terms of the loss-share agreements, the FDIC has agreed to reimburse the Bank the following amounts with respect to the covered assets (including covered loans): (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, and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC's initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement.

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In connection with the FNB Transaction, the Bank acquired loans both with and without evidence of credit quality deterioration since origination. The banking segment'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.

Covered loans held for investment are detailed in the table below and classified by portfolio segment (in thousands).

|                                   | Loans, excluding<br>PCI Loans |    | PCI<br>Loans |    | Total<br>Loans |
|-----------------------------------|-------------------------------|----|--------------|----|----------------|
| <b>June 30, 2014</b>              |                               |    |              |    |                |
| Commercial and industrial         | \$ 23,892                     | \$ | 26,124       | \$ | 50,016         |
| Real estate                       | 208,870                       |    | 489,355      |    | 698,225        |
| Construction and land development | 17,033                        |    | 79,739       |    | 96,772         |
| Consumer                          |                               |    |              |    |                |
| Covered loans, gross              | 249,795                       |    | 595,218      |    | 845,013        |
| Allowance for loan losses         | (201)                         |    | (3,914)      |    | (4,115)        |
| Covered loans, net of allowance   | \$ 249,594                    | \$ | 591,304      | \$ | 840,898        |

|                                   | Loans, excluding<br>PCI Loans |    | PCI<br>Loans |    | Total<br>Loans |
|-----------------------------------|-------------------------------|----|--------------|----|----------------|
| <b>December 31, 2013</b>          |                               |    |              |    |                |
| Commercial and industrial         | \$ 28,533                     | \$ | 38,410       | \$ | 66,943         |
| Real estate                       | 223,304                       |    | 564,678      |    | 787,982        |
| Construction and land development | 25,376                        |    | 126,068      |    | 151,444        |
| Consumer                          |                               |    |              |    |                |
| Covered loans, gross              | 277,213                       |    | 729,156      |    | 1,006,369      |
| Allowance for loan losses         | (179)                         |    | (882)        |    | (1,061)        |
| Covered loans, net of allowance   | \$ 277,034                    | \$ | 728,274      | \$ | 1,005,308      |

At June 30, 2014, the banking segment had covered loan concentrations (loans to borrowers engaged in similar activities) that exceeded 10% of total covered loans in its real estate portfolio. The areas of concentration within our covered real estate portfolio were construction and land development loans, non-construction residential real estate loans, and non-construction commercial real estate loans. At June 30, 2014, construction and land development loans, non-construction residential real estate loans, and non-construction commercial real estate loans were 13.45%, 34.09% and 41.98%, respectively, of the banking segment's total covered loans. The banking segment's covered loan concentrations were within regulatory guidelines at June 30, 2014.

**Allowance for Loan Losses**

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses inherent in our existing non-covered and covered loan portfolios. 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 Loan Review Committee of the Bank's board of directors.



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It is management's responsibility at the end of each quarter, or more frequently as deemed necessary, to analyze the level of the allowance for loan losses to ensure that it is appropriate for the estimated credit losses in the portfolio consistent with the Interagency Policy Statement on the Allowance for Loan and Lease Losses and the Receivables and Contingencies Topics of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC). Estimated credit losses are the probable current amount of loans that we 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.

We have 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.

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

While historical loss experience provides a reasonable starting point for the analysis, historical losses are not the sole basis upon which we 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 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.

We design our loan review program to identify and monitor problem loans by maintaining a credit grading process, requiring that timely and appropriate changes are 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. We review on an individual basis all loan relationships over \$0.5 million that exhibit probable or observed credit weaknesses, the top 25 loan relationships by dollar amount in each market we serve, and additional relationships necessary to achieve adequate coverage of our various lending markets.

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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, we had no material delinquencies in these types of loans.

The allowance is subject to regulatory examination and determination as to adequacy, which may take into account such factors as the methodology used to calculate the allowance and the size of the allowance. While we believe we have an appropriate allowance for our existing non-covered and covered portfolios at June 30, 2014, additional provisions for losses on existing loans may be necessary in the future. Within our non-covered portfolio, we recorded net charge-offs of \$2.3 million and \$1.7 million for the three months ended June 30, 2014 and 2013, respectively, and \$2.3 million and \$1.5 million for the six months ended June 30, 2014 and 2013, respectively. Our allowance for non-covered loan losses totaled \$36.4 million and \$33.2 million at June 30, 2014 and December 31, 2013, respectively. The ratio of the allowance for non-covered loan losses to total non-covered loans held for investment at June 30, 2014 and December 31, 2013 was 0.98% and 0.95%, respectively.

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In connection with the PlainsCapital Merger and the FNB Transaction, we acquired loans both with and without evidence of credit quality deterioration since origination. 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 in pools as well as on an individual loan basis. We have established under our PCI accounting policy a framework to aggregate certain acquired 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 common risk characteristics used for the pooling of the FNB PCI loans are risk grade and loan collateral type. The acquired loans were initially recorded at fair value with no carryover of any allowance for loan losses. Within our covered portfolio, we recorded net charge-offs of \$0.3 million for the six months ended June 30, 2014. Our allowance for covered loan losses totaled \$4.1 million and \$1.1 million at June 30, 2014 and December 31, 2013, respectively. The ratio of the allowance for covered loan losses to total covered loans held for investment at June 30, 2014 and December 31, 2013 was 0.49% and 0.11%, respectively.

Provisions for loan losses are charged to operations to record the total allowance for loan losses at a level deemed appropriate by the banking segment's management based on such factors as the volume and type of lending it conducted, the amount of non-performing loans and related collateral security, the present level of the allowance for loan losses, the results of recent regulatory examinations, generally accepted accounting principles, general economic conditions and other factors related to the ability to collect loans in its portfolio. The provision for loan losses, primarily in the banking segment, within our non-covered and covered portfolios was \$5.5 million and \$11.3 million for the three months ended June 30, 2014 and 2013, respectively, and \$8.8 million and \$24.3 million for the six months ended June 30, 2014 and 2013, respectively.

The following tables present the activity in our allowance for loan losses within our non-covered and covered loan portfolios for the periods presented (in thousands). Substantially all of the activity shown below occurred within the banking segment.

|   | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|---|-----------------------------|-----------|---------------------------|-----------|
|   | 2014                        | 2013      | 2014                      | 2013      |
| <b>Non-Covered Portfolio</b>                            |                             |           |                           |           |
| Balance, beginning of period                            | \$ 34,645                   | \$ 16,637 | \$ 33,241                 | \$ 3,409  |
| Provisions charged to operating expenses                | 4,083                       | 11,289    | 5,471                     | 24,294    |
| Recoveries of non-covered loans previously charged off: |                             |           |                           |           |
| Commercial and industrial                               | 629                         | 1,921     | 1,354                     | 2,415     |
| Real estate   | 82                          | 62        | 114                       | 201       |
| Construction and land development                       | 41                          | 44        | 163                       | 151       |
| Consumer  | 32                          | 20        | 50                        | 28        |
| Total recoveries  | 784                         | 2,047     | 1,681                     | 2,795     |
| Non-covered loans charged off:                          |                             |           |                           |           |
| Commercial and industrial                               | 2,924                       | 3,656     | 3,731                     | 4,094     |
| Real estate   | 72                          | 65        | 72                        | 96        |
| Construction and land development                       |                             |           |                           |           |
| Consumer  | 85                          | 15        | 159                       | 71        |
| Total charge-offs                                       | 3,081                       | 3,736     | 3,962                     | 4,261     |
| Net charge-offs   | (2,297)                     | (1,689)   | (2,281)                   | (1,466)   |
| Balance, end of period                                  | \$ 36,431                   | \$ 26,237 | \$ 36,431                 | \$ 26,237 |

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|   | Three Months Ended<br>June 30, 2014 |       | Six Months Ended<br>June 30, 2014 |       |
|---|-------------------------------------|-------|-----------------------------------|-------|
| <b>Covered Portfolio</b>                            |                                     |       |                                   |       |
| Balance, beginning of period                        | \$                                  | 2,665 | \$                                | 1,061 |
| Provisions charged to operating expenses            |                                     | 1,450 |                                   | 3,304 |
| Recoveries of covered loans previously charged off: |                                     |       |                                   |       |
| Commercial and industrial                           |                                     |       |                                   |       |
| Real estate   |                                     |       |                                   |       |
| Construction and land development                   |                                     |       |                                   |       |
| Consumer  |                                     |       |                                   |       |
| Total recoveries                                    |                                     |       |                                   |       |
| Covered loans charged off:                          |                                     |       |                                   |       |
| Commercial and industrial                           |                                     |       |                                   | 91    |
| Real estate   |                                     |       |                                   | 44    |
| Construction and land development                   |                                     |       |                                   | 115   |
| Consumer  |                                     |       |                                   |       |
| Total charge-offs                                   |                                     |       |                                   |       |
|   |                                     |       |                                   | 250   |
| Net charge-offs                                     |                                     |       |                                   |       |
|   |                                     |       |                                   | (250) |
| Balance, end of period                              | \$                                  | 4,115 | \$                                | 4,115 |

The distribution of the allowance for loan losses among loan types and the percentage of the loans for that type to gross loans, excluding unearned income, within our non-covered and covered loan portfolios are presented in the tables below (dollars in thousands).

|   | June 30, 2014 |                                       | December 31, 2013 |                                       |
|---|---------------|---------------------------------------|-------------------|---------------------------------------|
|   | Reserve       | % of<br>Gross<br>Non-Covered<br>Loans | Reserve           | % of<br>Gross<br>Non-Covered<br>Loans |
| <b>Non-Covered Portfolio</b>                              |               |                                       |                   |                                       |
| Commercial and industrial                                 | \$ 18,062     | 45.27%                                | \$ 16,865         | 46.58%                                |
| Real estate (including construction and land development) | 18,084        | 53.25%                                | 16,288            | 51.84%                                |
| Consumer  | 285           | 1.48%                                 | 88                | 1.58%                                 |
| Total   | \$ 36,431     | 100.00%                               | \$ 33,241         | 100.00%                               |

|   | June 30, 2014 |                                   | December 31, 2013 |                                   |
|---|---------------|-----------------------------------|-------------------|-----------------------------------|
|   | Reserve       | % of<br>Gross<br>Covered<br>Loans | Reserve           | % of<br>Gross<br>Covered<br>Loans |
| <b>Covered Portfolio</b>                                  |               |                                   |                   |                                   |
| Commercial and industrial                                 | \$ 1,146      | 5.92%                             | \$ 1,053          | 6.65%                             |
| Real estate (including construction and land development) | 2,551         | 94.08%                            | 8                 | 93.35%                            |
| Consumer  | 418           | 0.00%                             |                   | 0.00%                             |
| Total   | \$ 4,115      | 100.00%                           | \$ 1,061          | 100.00%                           |

*Potential Problem Loans*

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Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor's potential operating or financial difficulties. Management monitors these loans and reviews their performance on a regular basis. Potential problem loans contain potential weaknesses that could improve, persist or further deteriorate. If such potential weaknesses persist without improving, the loan is subject to downgrade, typically to substandard, in three to six months. Within our non-covered loan portfolio at June 30, 2014, we had nine credit relationships totaling \$22.9 million of potential problem loans, which are assigned a grade of special mention within our risk grading matrix. At December 31, 2013, we had ten credit relationships totaling \$24.7 million of non-covered potential problem loans. Within our covered loan portfolio at June 30, 2014, we had two credit relationship totaling \$1.7 million of potential problem loans assigned a grade of special mention within our risk grading matrix, compared with two credit relationships totaling \$3.3 million at December 31, 2013.

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The following table presents our components of non-covered non-performing assets (dollars in thousands).

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| Non-covered loans accounted for on a non-accrual basis:                     |                  |                      |
| Commercial and industrial   | \$ 14,762        | \$ 16,730            |
| Real estate   | 6,296            | 6,511                |
| Construction and land development   | 863              | 112                  |
| Consumer  |                  |                      |
|   | \$ 21,921        | \$ 23,353            |
| Non-covered non-performing loans as a percentage of total non-covered loans | 0.43%            | 0.51%                |
| Non-covered other real estate owned   | \$ 4,353         | \$ 4,805             |
| Other repossessed assets  | \$ 1,719         | \$ 13                |
| Non-covered non-performing assets   | \$ 27,993        | \$ 28,171            |
| Non-covered non-performing assets as a percentage of total assets           | 0.30%            | 0.32%                |
| Non-covered loans past due 90 days or more and still accruing               | \$ 1             | \$ 534               |
| Troubled debt restructurings included in accruing non-covered loans         | \$ 406           | \$ 1,055             |

At June 30, 2014, total non-covered non-performing assets decreased \$0.2 million to \$28.0 million, compared with \$28.2 million at December 31, 2013. Non-covered non-performing loans totaled \$21.9 million at June 30, 2014 and \$23.4 million at December 31, 2013. At June 30, 2014, non-covered non-accrual loans included 17 commercial and industrial relationships with loans of \$12.0 million secured by accounts receivable, inventory, oil and gas properties, aircraft and life insurance, and a total of \$1.5 million in lease financing receivables. Non-covered non-accrual loans at June 30, 2014 also included \$6.3 million characterized as real estate loans, including two commercial real estate loan relationships of \$0.5 million and loans secured by residential real estate of \$5.8 million, \$3.9 million of which were classified as loans held for sale, as well as construction and land development loans of \$0.9 million. At December 31, 2013, non-covered non-accrual loans included five commercial and industrial relationships with loans of \$14.0 million secured by accounts receivable, inventory, aircraft and life insurance, and a total of \$1.0 million in lease financing receivables. Non-covered non-accrual loans at December 31, 2013 also included \$6.5 million characterized as real estate loans, including three commercial real estate loan relationships of \$2.5 million and loans secured by residential real estate of \$3.5 million, substantially all of which were classified as loans held for sale, as well as construction and land development loans of \$0.1 million.

Non-covered OREO decreased \$0.4 million to \$4.4 million at June 30, 2014, compared with \$4.8 million at December 31, 2013. Changes in non-covered OREO included the disposal of seven properties totaling \$2.4 million and the addition of five properties totaling \$2.4 million. At June 30, 2014, non-covered OREO included commercial properties of \$0.4 million, commercial real estate property consisting of parcels of unimproved land of \$2.1 million and residential lots under development of \$1.9 million. At December 31, 2013, non-covered OREO included commercial properties of \$4.2 million, commercial real estate property consisting of parcels of unimproved land of \$0.5 million and residential lots under development of \$0.1 million.

At June 30, 2014, troubled debt restructurings ( TDRs ) granted on non-covered loans totaled \$10.3 million, of which \$0.4 million relate to non-covered PCI loans that are considered to be performing due to the application of the accretion method and non-covered non-performing loans of \$9.9 million for which discount accretion has been suspended. At December 31, 2013, TDRs granted on non-covered loans totaled \$11.4 million. These TDRs were comprised of \$1.1 million of non-covered PCI loans that are considered to be performing due to the application of the accretion method and non-covered non-performing loans of \$10.3 million for which discount accretion has been suspended.

Non-covered loans past due 90 days or more and still accruing were de minimis at June 30, 2014, compared to a total of \$0.5 million at December 31, 2013 that included secured commercial and industrial loans, and a real estate loan.



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The following table presents components of our covered non-performing assets (dollars in thousands).

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| Covered loans accounted for on a non-accrual basis:                 |                  |                      |
| Commercial and industrial   | \$ 2,095         | \$ 973               |
| Real estate   | 12,620           | 249                  |
| Construction and land development                                   | 1,919            | 575                  |
| Consumer  |                  |                      |
|   | \$ 16,634        | \$ 1,797             |
| Covered non-performing loans as a percentage of total covered loans | 1.97%            | 0.18%                |
| Covered other real estate owned                                     | \$ 142,174       | \$ 142,833           |
| Other repossessed assets  | \$               | \$                   |
| Covered non-performing assets                                       | \$ 158,808       | \$ 144,630           |
| Covered non-performing assets as a percentage of total assets       | 1.69%            | 1.62%                |
| Covered loans past due 90 days or more and still accruing           | \$ 272           | \$                   |
| Troubled debt restructurings included in accruing covered loans     | \$               | \$                   |

At June 30, 2014, covered non-performing assets increased by \$14.2 million to \$158.8 million, compared with \$144.6 million at December 31, 2013, primarily due to an increase in covered non-accrual loans of \$14.8 million. Covered non-performing loans totaled \$16.6 million at June 30, 2014 and \$1.8 million at December 31, 2013. At June 30, 2014, covered non-performing loans included seven commercial and industrial relationships with loans of \$1.0 million secured by accounts receivable and inventory, two commercial real estate loan relationships of \$10.9 million, eleven residential real estate loan relationships of \$1.7 million, as well as construction and land development loans of \$1.9 million. At December 31, 2013, covered non-performing loans of \$1.8 million included one commercial and industrial relationship with loans of \$1.0 million secured by accounts receivable, inventory and equipment. Covered non-accrual loans at December 31, 2013 also included one commercial real estate loan relationship of \$0.2 million, as well as construction and land development loans of \$0.6 million.

OREO acquired in the FNB Transaction that is subject to the FDIC loss-share agreements is referred to as covered OREO and reported separately in our consolidated balance sheets. Covered OREO decreased \$0.6 million to \$142.2 million at June 30, 2014, compared with \$142.8 million at December 31, 2013. The decrease was primarily due to the disposal of 125 properties totaling \$34.7 million, partially offset by the addition of 87 properties totaling \$34.5 million. At June 30, 2014, covered OREO included commercial properties of \$93.9 million, commercial real estate property consisting of parcels of unimproved land of \$21.4 million and residential lots under development of \$26.9 million. At December 31, 2013, covered OREO included commercial properties of \$90.5 million, commercial real estate property consisting of parcels of unimproved land of \$21.4 million and residential lots under development of \$30.9 million.

Covered loans past due 90 days or more and still accruing totaled \$0.3 million at June 30, 2014 and included secured commercial and industrial loans, a construction and land development loan, and commercial and residential real estate loans.

**Insurance Losses and Loss Adjustment Expenses**

At June 30, 2014 and December 31, 2013, our reserves for unpaid losses and LAE were \$35.1 million and \$27.5 million, respectively. The liability for insurance losses and LAE represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims that have not yet been reported. Separately for each of NLIC and ASIC and each line of business, our actuaries estimate the liability for unpaid losses and

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LAE by first estimating ultimate losses and LAE amounts for each year, prior to recognizing the impact of reinsurance.

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Insured losses for a given accident year change in value over time as additional information on claims is received, as claim conditions change and as new claims are reported. This process is commonly referred to as loss development. To project ultimate losses and LAE, our actuaries examine the paid and reported losses and LAE for each accident year and multiply these values by a loss development factor. The selected loss development factors are based upon a review of the loss development patterns indicated in the companies' historical loss triangles and applicable insurance industry loss development factors.

The reserve analysis performed by our actuaries provides preliminary central estimates of the unpaid losses and LAE. At each quarter-end, the results of the reserve analysis are summarized and discussed with our senior management. The senior management group considers many factors in determining the amount of reserves to record for financial statement purposes. These factors include the extent and timing of any recent catastrophic events, historical pattern and volatility of the actuarial indications, the sensitivity of the actuarial indications to changes in paid and reported loss patterns, the consistency of claims handling processes, the consistency of case reserving practices, changes in our pricing and underwriting, and overall pricing and underwriting trends in the insurance market.

**Deposits**

The banking segment's major source of funds and liquidity is its deposit base. Deposits provide funding for its investment in loans and securities. Interest paid for deposits must be managed carefully to control the level of interest expense and overall net interest margin. The composition of the deposit base (time deposits versus interest-bearing demand deposits and savings), as discussed in more detail within the section entitled Liquidity and Capital Resources - Banking Segment below, is constantly changing due to the banking segment's needs and market conditions. Overall, average deposits totaled \$6.5 billion for the six months ended June 30, 2014, an increase from average deposits of \$4.7 billion for the six months ended June 30, 2013. The significant year-over-year increase in average deposits was primarily due to those deposits assumed as a part of the FNB Transaction. The table below presents the average balance of deposits and the average rate paid on those deposits (dollars in thousands).

|                                     | 2014            |                   | Six Months Ended June 30, 2013 |                   | Year Ended December 31, 2013 |                   |
|-------------------------------------|-----------------|-------------------|--------------------------------|-------------------|------------------------------|-------------------|
|                                     | Average Balance | Average Rate Paid | Average Balance                | Average Rate Paid | Average Balance              | Average Rate Paid |
| Noninterest-bearing demand deposits | \$ 1,741,409    | 0.00%             | \$ 1,184,990                   | 0.00%             | \$ 1,370,029                 | 0.00%             |
| Interest-bearing demand deposits    | 2,310,167       | 0.22%             | 1,813,333                      | 0.25%             | 1,930,622                    | 0.24%             |
| Savings deposits                    | 286,734         | 0.21%             | 179,302                        | 0.36%             | 247,789                      | 0.32%             |
| Certificates of deposit             | 2,138,125       | 0.38%             | 1,475,567                      | 0.59%             | 1,745,483                    | 0.54%             |
|                                     | \$ 6,476,435    | 0.21%             | \$ 4,653,192                   | 0.30%             | \$ 5,293,923                 | 0.28%             |

**Borrowings**

Our borrowings are shown in the table below (dollars in thousands).

June 30, 2014

December 31, 2013

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|                                | Balance      | Average<br>Rate Paid | Balance    | Average<br>Rate Paid |
|--------------------------------|--------------|----------------------|------------|----------------------|
| Short-term borrowings          | \$ 1,187,193 | 0.32%                | \$ 342,087 | 0.36%                |
| Notes payable                  | 55,584       | 4.62%                | 56,327     | 6.33%                |
| Junior subordinated debentures | 67,012       | 3.52%                | 67,012     | 3.59%                |
|                                | \$ 1,309,789 | 0.97%                | \$ 465,426 | 2.10%                |

Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase and short-term bank loans. The \$845.1 million increase in short-term borrowings at June 30, 2014 compared with December 31, 2013 included increases of \$750.0 million in borrowings at the FHLB, \$68.2 million in federal funds purchased and \$22.3 million in securities sold under agreements to repurchase. These increases were the result of higher funding requirements associated with the increase in our mortgage origination segment's balance on its warehouse line of credit with the Bank, a decrease in deposits, and a slight increase in loans. Notes payable at June 30, 2014 of \$55.6 million is comprised of insurance segment term notes and nonrecourse notes owed by First Southwest.

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*Liquidity and Capital Resources*

Hilltop is a financial holding company whose assets primarily consist of the stock of its subsidiaries and invested assets. Hilltop's primary investment objectives, as a holding company, are to preserve capital and have available cash resources to utilize in making acquisitions. At June 30, 2014, Hilltop had approximately \$158 million in freely available cash and cash equivalents. If necessary or appropriate, we may also finance acquisitions with the proceeds from equity or debt issuances. The current short-term liquidity needs of Hilltop include operating expenses, dividends on preferred stock and the cash consideration associated with the SWS merger.

*Pending Merger*

On March 31, 2014, we entered into a definitive merger agreement with SWS providing for the merger of SWS with and into a subsidiary of Hilltop formed for the purpose of facilitating this transaction (the "merger"). Under the terms of the merger agreement, SWS stockholders will receive per share consideration of 0.2496 shares of Hilltop common stock and \$1.94 of cash, equating to \$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. We intend to fund the cash portion of the consideration, currently estimated at approximately \$78 million in the aggregate, 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.

*Series B Preferred Stock*

As a result of the PlainsCapital Merger, the outstanding shares of PlainsCapital Corporation's Non-Cumulative Perpetual Preferred Stock, Series C, all of which were held by the U.S. Treasury, were converted on a one-for-one basis into shares of Hilltop Series B Preferred Stock. The terms of our Series B Preferred Stock provide for the payment of non-cumulative dividends on a quarterly basis. The dividend rate, as a percentage of the liquidation amount, fluctuated until December 31, 2013 based upon changes in the level of qualified small business lending (QSBL) by the Bank. The shares of Hilltop Series B Preferred Stock are senior to shares of our common stock with respect to dividends and liquidation preference, and qualify as Tier 1 Capital for regulatory purposes. At both June 30, 2014 and December 31, 2013, \$114.1 million of our Series B Preferred Stock was outstanding. During the three months ended June 30, 2014, we accrued dividends of \$1.4 million on the Hilltop Series B Preferred Stock.

The dividend rate on the Hilltop Series B Preferred Stock is fixed at 5.0% from January 1, 2014 until March 26, 2016, based upon our level of QSBL at September 30, 2013. Beginning March 27, 2016, the dividend rate on any outstanding shares of Hilltop Series B Preferred Stock will be fixed at nine percent (9%) per annum.

*Loss-Share Agreements*

In connection with the FNB Transaction, the Bank entered into two loss-share agreements with the FDIC that collectively cover \$1.2 billion of loans and OREO acquired in the FNB Transaction, which we refer to as "covered assets". Pursuant to the loss-share agreements, the FDIC has

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agreed to reimburse the Bank the following amounts with respect to the covered assets: (i) 80% of losses on the first \$240.4 million of losses incurred; (ii) 0% of losses in excess of \$240.4 million up to and including \$365.7 million of losses incurred; and (iii) 80% of losses in excess of \$365.7 million of losses incurred. The Bank has also agreed to reimburse the FDIC for any subsequent recoveries. The loss-share agreements for commercial and single family residential loans are in effect for 5 years and 10 years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for 8 years and 10 years, respectively, from the Bank Closing Date. In accordance with the loss-share agreements, the Bank may be required to make a true-up payment to the FDIC approximately ten years following the Bank Closing Date if the FDIC's initial estimate of losses on covered assets is greater than the actual realized losses. The true-up payment is calculated using a defined formula set forth in the P&A Agreement.

### *Regulatory Capital*

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements may prompt certain actions by regulators that, if undertaken, could have a direct material adverse effect on our financial condition and results of operations. Under capital adequacy and regulatory requirements,

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we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

At June 30, 2014, Hilltop exceeded all regulatory capital requirements with a total capital to risk weighted assets ratio of 18.79%, Tier 1 capital to risk weighted assets ratio of 18.11% and a Tier 1 capital to average assets, or leverage, ratio of 13.51%. At June 30, 2014, the Bank was also considered to be well-capitalized under regulatory requirements. We discuss regulatory capital requirements in more detail in Note 14 to our consolidated financial statements.

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

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

The final rules also provide for a number of adjustments to and deductions from the new common equity Tier 1 capital ratio, as well as changes to the calculation of risk weighted assets which is expected to increase the absolute level. Under current capital standards, the effects of accumulated other comprehensive items included in capital are excluded for the purposes of determining regulatory capital ratios. Under Basel III, the effects of certain accumulated other comprehensive items are not excluded; however, non-advanced approaches banking organizations, including Hilltop and the Bank, may make a one-time permanent election to continue to exclude these items. Hilltop and Bank expect to make this election in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of our securities portfolio. In addition, deductions include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from the common equity Tier 1 capital ratio to the extent that any one such category exceeds 10% of the common equity Tier 1 capital ratio or all such categories in the aggregate exceed 15% of the common equity Tier 1 capital ratio. Further, deferred tax assets which are related to operating losses and tax credit carry forward are excluded from the common equity Tier 1 capital ratio.

The final rules did not address the proposed liquidity coverage ratio test and the net stable funding ratio test called for by the Basel III liquidity framework. Management will continue to monitor the developments related to these proposals and their potential impact on our liquidity requirements.

Management believes that, as of June 30, 2014, Hilltop and the Bank would meet all applicable capital adequacy requirements under the Basel III capital rules for banks with less than \$15 billion in assets on a fully phased-in basis as if such requirements were currently in effect. For additional information concerning the Basel III capital rules, refer to the discussion under the caption Government Supervision and Regulation PlainsCapital Bank BASEL III set forth in Part I, Item I. of our Annual Report on Form 10-K.

*Cash Flow Activities*

Cash and cash equivalents (consisting of cash and due from banks and federal funds sold), totaled \$688.8 million at June 30, 2014, a decrease of \$57.2 million from \$746.0 million at December 31, 2013. Deposit flows, calls of investment securities and borrowed funds, and prepayments of loans and mortgage-backed securities are strongly influenced by interest rates, general and local economic conditions and competition in the marketplace. These factors reduce the predictability of the timing of these sources of funds.



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Cash used in operations during the six months ended June 30, 2014 was \$291.7 million, a decrease in cash flow of \$306.4 million compared with the same period in 2013. Cash used in operations increased primarily due to reductions in cash provided by our mortgage loan origination activities.

Cash provided by our investment activities during the six months ended June 30, 2014 was \$40.6 million, including \$68.6 million from net changes in loans and \$38.3 million from sales of premises and equipment and other real estate owned, partially offset by net cash paid for FHLB and FRB stock of \$31.4 million, net purchases of premises and equipment and other assets of \$19.8 million and net purchases of securities in our investment portfolio of \$15.0 million. Cash used in our investment activities during the six months ended June 30, 2013 of \$206.3 million primarily included net purchases of securities for investment of \$127.5 million, \$51.0 million for the origination of loans held for investment and net cash paid for FHLB and FRB stock of \$21.2 million. The increase in cash provided by investing activities during the six months ended June 30, 2014, compared to the same period in 2013, was primarily due to reduced net purchases of securities driven by market conditions.

Cash provided by financing activities during the six months ended June 30, 2014 was \$193.9 million, an increase in cash provided of \$102.7 million compared with the same period in 2013. The increase in cash provided by financing activities was due primarily to a greater increase in short-term borrowings during the six months ended June 30, 2014, offset by a greater decrease in deposits during the six months ended June 30, 2014, compared with the same period in 2013.

*Banking Segment*

Within our banking segment, liquidity refers to the measure of our ability to meet our customers' short-term and long-term deposit withdrawals and anticipated and unanticipated increases in loan demand without penalizing earnings. Interest rate sensitivity involves the relationships between rate-sensitive assets and liabilities and is an indication of the probable effects of interest rate fluctuations on our net interest income.

Our asset and liability group is responsible for continuously monitoring our liquidity position to ensure that assets and liabilities are managed in a manner that will meet our short-term and long-term cash requirements. Funds invested in short-term marketable instruments, the continuous maturing of other interest-earning assets, cash flows from self-liquidating investments such as mortgage-backed securities and collateralized mortgage obligations, the possible sale of available for sale securities, and the ability to securitize certain types of loans provide sources of liquidity from an asset perspective. The liability base provides sources of liquidity through deposits and the maturity structure of short-term borrowed funds. For short-term liquidity needs, we utilize federal fund lines of credit with correspondent banks, securities sold under agreements to repurchase, borrowings from the Federal Reserve and borrowings under lines of credit with other financial institutions. For intermediate liquidity needs, we utilize advances from the FHLB. To supply liquidity over the longer term, we have access to brokered certificates of deposit, term loans at the FHLB and borrowings under lines of credit with other financial institutions.

We had deposits of \$6.2 billion at June 30, 2014, a decrease of \$567.6 million from \$6.7 billion at December 31, 2013. This decrease is primarily due to seasonal factors related to our customers' requirements to satisfy year-end tax obligations and our strategic decision to offer lower renewal rates on certain time deposits acquired in the FNB Transaction that conform to the legacy PlainsCapital Bank interest rate structure. Deposit flows are affected by the level of market interest rates, the interest rates and products offered by competitors, the volatility of equity markets and other factors. At June 30, 2014, money market deposits, including brokered deposits, were \$959.4 million; time deposits, including brokered deposits, were \$1.9 billion; and noninterest bearing demand deposits were \$1.8 billion. Money market deposits, including brokered deposits, decreased by \$195.9 million from \$1.2 billion and time deposits, including brokered deposits, decreased \$419.9 million from \$2.3 billion at December 31, 2013.

The Bank's 15 largest depositors, excluding Hilltop and First Southwest, accounted for 13.26% of the Bank's total deposits, and the Bank's five largest depositors, excluding First Southwest, accounted for 8.63% of the Bank's total deposits at June 30, 2014. The loss of one or more of our largest Bank customers, or a significant decline in our deposit balances due to ordinary course fluctuations related to these customers' businesses, could adversely affect our liquidity and might require us to raise deposit rates to attract new deposits, purchase federal funds or borrow funds on a short-term basis to replace such deposits. We have not experienced any liquidity issues to date with respect to brokered deposits or our other large balance deposits, and we believe alternative sources of funding are available to more than compensate for the loss of one or more of these customers.

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*Mortgage Origination Segment*

PrimeLending funds the mortgage loans it originates through a warehouse line of credit of up to \$1.5 billion maintained with the Bank. At June 30, 2014, PrimeLending had outstanding borrowings of \$1.3 billion against the warehouse line of credit. PrimeLending sells substantially all mortgage loans it originates to various investors in the secondary market, the majority with servicing released. As these mortgage loans are sold in the secondary market, PrimeLending pays down its warehouse line of credit with the Bank. In addition, PrimeLending has an available line of credit with JPMorgan Chase Bank, NA ( JPMorgan Chase ) of up to \$1.0 million. At June 30, 2014, PrimeLending had no borrowings under the JPMorgan Chase line of credit.

*Insurance Segment*

Our insurance operating subsidiary's primary investment objectives is to preserve capital and manage for a total rate of return. NLC's strategy is to purchase securities in sectors that represent the most attractive relative value. Bonds, cash and short-term investments of \$210.4 million, or 91.6%, equity investments of \$13.9 million and other investments of \$5.5 million comprised NLC's \$229.8 million in total cash and investments at June 30, 2014. NLC does not currently have any significant concentration in both direct and indirect guarantor exposure or any investments in subprime mortgages. NLC has custodial agreements with Wells Fargo and an investment management agreement with DTF Holdings, LLC.

*Financial Advisory Segment*

FSC relies on its equity capital, short-term bank borrowings, interest-bearing and non-interest-bearing client credit balances, correspondent deposits, securities lending arrangements, repurchase agreement financings and other payables to finance its assets and operations. FSC has credit arrangements with four unaffiliated banks of up to \$305.0 million, which are used to finance securities owned, securities held for correspondent accounts, receivables in customer margin accounts and underwriting activities. These credit arrangements are provided on an as offered basis and are not committed lines of credit. At June 30, 2014, FSC had borrowed \$102.0 million under these credit arrangements.

*Impact of Inflation and Changing Prices*

Our consolidated financial statements included herein have been prepared in accordance with GAAP, which presently require us to measure financial position and operating results primarily in terms of historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude as the inflation rate. Interest rates are highly sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, the influence of general and local economic conditions and the monetary and fiscal policies of the U.S. government, its agencies and various other governmental regulatory authorities.

*Off-Balance Sheet Arrangements; Commitments; Guarantees*

In the normal course of business, we enter into various transactions, which, in accordance with GAAP, are not included in our consolidated balance sheets. We enter into these transactions to meet the financing needs of our customers. These transactions include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in our consolidated balance sheets.

We enter into contractual loan commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Substantially all of our commitments to extend credit are contingent upon customers maintaining specific credit standards until the time of loan funding. We minimize our exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures. We assess the credit risk associated with certain commitments to extend credit and have recorded a liability related to such credit risk in our consolidated financial statements.

Standby letters of credit are written conditional commitments issued by us to guarantee the performance of a customer to a third party. In the event the customer does not perform in accordance with the terms of the agreement with the third party, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to

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make is represented by the contractual amount of the commitment. If the commitment is funded, we would be entitled to seek recovery from the customer. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

In the aggregate, the Bank had outstanding unused commitments to extend credit of \$1.2 billion at June 30, 2014 and outstanding financial and performance standby letters of credit of \$40.6 million at June 30, 2014.

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.

*Critical Accounting Policies and Estimates*

Our accounting policies are fundamental to understanding our management's discussion and analysis of our results of operations and financial condition. We have identified certain significant accounting policies which involve a higher degree of judgment and complexity in making certain estimates and assumptions that affect amounts reported in our consolidated financial statements. The significant accounting policies which we believe to be the most critical in preparing our consolidated financial statements relate to Allowance for Loan Losses, FDIC Indemnification Asset, Reserve for Losses and Loss Adjustment Expenses, Goodwill and Identifiable Intangible Assets, Loan Indemnification Liability, Mortgage Servicing Rights and Acquisition Accounting. Since December 31, 2013, there have been no changes in critical accounting policies as further described under *Critical Accounting Policies and Estimates* and Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Our assessment of market risk as of June 30, 2014 indicates there are no material changes in the quantitative and qualitative disclosures from those previously reported in our Annual Report on Form 10-K for the year ended December 31, 2013, except as discussed below.

The primary objective of the following information is to provide forward-looking quantitative and qualitative information about our potential exposure to market risks. Market risk represents the risk of loss that may result from changes in value of a financial instrument as a result of changes in interest rates, market prices and the credit perception of an issuer. The disclosure is not meant to be a precise indicator of expected future losses, but rather an indicator of reasonably possible losses, and therefore our actual results may differ from any of the following projections. This forward-looking information provides an indicator of how we view and manage our ongoing market risk exposures.

*Banking Segment*

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The banking segment is engaged primarily in the business of investing funds obtained from deposits and borrowings in interest-earning loans and investments, and our primary component of market risk is sensitivity to changes in interest rates. Consequently, our earnings depend to a significant extent on our net interest income, which is the difference between interest income on loans and investments and our interest expense on deposits and borrowings. To the extent that our interest-bearing liabilities do not reprice or mature at the same time as our interest-bearing assets, we are subject to interest rate risk and corresponding fluctuations in net interest income.

There are several common sources of interest rate risk that must be effectively managed if there is to be minimal impact on our earnings and capital. Repricing risk arises largely from timing differences in the pricing of assets and liabilities. Reinvestment risk refers to the reinvestment of cash flows from interest payments and maturing assets at lower or higher rates. Basis risk exists when different yield curves or pricing indices do not change at precisely the same time or in the same magnitude such that assets and liabilities with the same maturity are not all affected equally. Yield curve risk refers to unequal movements in interest rates across a full range of maturities.

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We have employed asset/liability management policies that attempt to manage our interest-earning assets and interest-bearing liabilities, thereby attempting to control the volatility of net interest income, without having to incur unacceptable levels of risk. We employ procedures which include interest rate shock analysis, repricing gap analysis and balance sheet decomposition techniques to help mitigate interest rate risk in the ordinary course of business. In addition, the asset/liability management policies permit the use of various derivative instruments to manage interest rate risk or hedge specified assets and liabilities.

An interest rate sensitive asset or liability is one that, within a defined time period, either matures or experiences an interest rate change in line with general market interest rates. The management of interest rate risk is performed by analyzing the maturity and repricing relationships between interest-earning assets and interest-bearing liabilities at specific points in time ( GAP ) and by analyzing the effects of interest rate changes on net interest income over specific periods of time by projecting the performance of the mix of assets and liabilities in varied interest rate environments. Interest rate sensitivity reflects the potential effect on net interest income resulting from a movement in interest rates. A company is considered to be asset sensitive, or have a positive GAP, when the amount of its interest-earning assets maturing or repricing within a given period exceeds the amount of its interest-bearing liabilities also maturing or repricing within that time period. Conversely, a company is considered to be liability sensitive, or have a negative GAP, when the amount of its interest-bearing liabilities maturing or repricing within a given period exceeds the amount of its interest-earning assets also maturing or repricing within that time period. During a period of rising interest rates, a negative GAP would tend to affect net interest income adversely, while a positive GAP would tend to result in an increase in net interest income. During a period of falling interest rates, a negative GAP would tend to result in an increase in net interest income, while a positive GAP would tend to affect net interest income adversely. However, it is our intent to remain relatively balanced so that changes in rates do not have a significant impact on earnings.

As illustrated in the table below, the banking segment is asset sensitive overall. Loans that adjust daily or monthly to the Wall Street Journal Prime rate comprise a large percentage of interest sensitive assets and are the primary cause of the banking segment's asset sensitivity. To help neutralize interest rate sensitivity, the banking segment has kept the terms of most of its borrowings under one year as shown in the following table (dollars in thousands).

|  | June 30, 2014       |                         |                        |                         |            |  |              |
|--|---------------------|-------------------------|------------------------|-------------------------|------------|--|--------------|
|  | 3 Months or<br>Less | > 3 Months to<br>1 Year | > 1 Year to<br>3 Years | > 3 Years to<br>5 Years | > 5 Years  |  | Total        |
| <b><u>Interest sensitive assets:</u></b>                               |                     |                         |                        |                         |            |  |              |
| Loans  | \$ 3,197,277        | \$ 624,873              | \$ 721,139             | \$ 284,195              | \$ 671,708 |  | \$ 5,499,192 |
| Securities   | 563,121             | 155,138                 | 111,599                | 39,106                  | 191,563    |  | 1,060,527    |
| Federal funds sold and securities purchased under agreements to resell | 14,813              |                         |                        |                         |            |  | 14,813       |
| Other interest sensitive assets  | 341,181             |                         |                        |                         |            |  | 341,181      |
| Total interest sensitive assets  | 4,116,392           | 780,011                 | 832,738                | 323,301                 | 863,271    |  | 6,915,713    |
| <b><u>Interest sensitive liabilities:</u></b>                          |                     |                         |                        |                         |            |  |              |
| Interest bearing checking  | \$ 2,203,098        |                         |                        |                         |            |  | \$ 2,203,098 |
| Savings  | 259,540             |                         |                        |                         |            |  | 259,540      |
| Time deposits  | 588,856             | 875,132                 | 276,967                | 130,068                 | 14,353     |  | 1,885,376    |
| Notes payable & other borrowings                                       | 1,004,440           | 75,488                  | 1,389                  | 745                     | 5,290      |  | 1,087,352    |
| Total interest sensitive liabilities                                   | 4,055,934           | 950,620                 | 278,356                | 130,813                 | 19,643     |  | 5,435,366    |

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|   |    |        |    |           |    |         |    |         |    |           |    |           |
|---|----|--------|----|-----------|----|---------|----|---------|----|-----------|----|-----------|
| Interest sensitivity gap  | \$ | 60,458 | \$ | (170,609) | \$ | 554,382 | \$ | 192,488 | \$ | 843,628   | \$ | 1,480,347 |
| Cumulative interest sensitivity gap                             | \$ | 60,458 | \$ | (110,151) | \$ | 444,231 | \$ | 636,719 | \$ | 1,480,347 |    |           |
| Percentage of cumulative gap to total interest sensitive assets |    | 0.87%  |    | -1.59%    |    | 6.42%   |    | 9.21%   |    | 21.41%    |    |           |

The positive GAP in the interest rate analysis indicates that banking segment net interest income would generally rise if rates increase. Because of inherent limitations in interest rate GAP analysis, the banking segment uses multiple interest rate risk measurement techniques. Simulation analysis is used to subject the current repricing conditions to rising and falling interest rates in increments and decrements of 1%, 2% and 3% to determine the effect on net interest income changes for the next twelve months. The banking segment also measures the effects of changes in interest rates on market value of equity by discounting projected cash flows of deposits and loans. Market value changes in the investment portfolio are estimated by discounting future cash flows and using duration analysis. Investment security prepayments are estimated using current market information. We believe the simulation analysis presents a more accurate picture than the



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GAP analysis. Simulation analysis recognizes that deposit products may not react to changes in interest rates as quickly or with the same magnitude as earning assets contractually tied to a market rate index. The sensitivity to changes in market rates varies across deposit products. Also, unlike GAP analysis, simulation analysis takes into account the effect of embedded options in the securities and loan portfolios as well as any off-balance-sheet derivatives.

The table below shows the estimated impact of increases of 1%, 2% and 3% and a decrease of 0.5% in interest rates on net interest income and on economic value of equity for the banking segment at June 30, 2014 (dollars in thousands).

| Change in Interest Rates (basis points) | Changes in Net Interest Income |         | Changes in Economic Value of Equity |         |
|---|--------------------------------|---------|-------------------------------------|---------|
|   | Amount                         | Percent | Amount                              | Percent |
| +300                                    | \$ (3,821)                     | -1.51%  | \$ (73,215)                         | -5.95%  |
| +200                                    | \$ (12,028)                    | -4.75%  | \$ (61,258)                         | -4.98%  |
| +100                                    | \$ (14,390)                    | -5.68%  | \$ (24,987)                         | -2.03%  |
| -50                                     | \$ 1,026                       | 0.40%   | \$ 15,910                           | 1.29%   |

The projected changes in net interest income and market value of equity to changes in interest rates at June 30, 2014 were in compliance with established internal policy guidelines. These projected changes are based on numerous assumptions of growth and changes in the mix of assets or liabilities.

The historically low level of interest rates, combined with the existence of rate floors that are in effect for a significant portion of the loan portfolio, are projected to cause yields on our earning assets to rise more slowly than increases in market interest rates. As a result, in a rising interest rate environment, our interest rate margins are projected to compress until the rise in market interest rates is sufficient to allow our loan portfolio to reprice above applicable rate floors.

**Item 4. Controls and Procedures***Evaluation of Disclosure Controls and Procedures*

Our management, with the supervision and participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report.

Based upon that evaluation, our Principal Executive Officer and Principal Financial Officer concluded that, as of the end of such period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to the Company's management, including our Principal Executive Officer and Principal Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control over Financial Reporting*

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

For a description of material pending legal proceedings, see the discussion set forth under the heading "Legal Matters" in Note 11 to our Consolidated Financial Statements, which is incorporated by reference herein.

**Item 1A. Risk Factors.**

Except as follows, there have been no material changes to the risk factors disclosed under "Item 1A. Risk Factors" of our Annual Report on Form 10-K. For additional information concerning our risk factors, please refer to "Item 1A. Risk Factors" of our Annual Report on Form 10-K.

**Risks Related to the Merger**

*We may fail to realize all of the anticipated benefits of the pending merger.*

The success of the merger will depend on, among other things, the ability to achieve certain operating results at SWS. If the financial condition or result of operations of SWS is materially different than those that we forecasted, the anticipated benefits of the acquisition may not be realized fully, or at all, or may take longer to realize than expected.

Hilltop and SWS have operated and, until the completion of the merger, will continue to operate, independently. The companies may have difficulty addressing possible differences in corporate cultures and management philosophies. It is also possible that clients, customers, depositors and counterparties of SWS could choose to discontinue their relationships with the company post-merger, which would adversely affect our future performance.

*Our results of operations and the market price of our common stock after the merger may be affected by factors different from those currently affecting our results of operations and the market price of our common stock.*

Our business differs in important respects from the business of SWS and, accordingly, the results of operations of the combined company and the market price of the combined company's common stock may be affected by factors different from those currently affecting the independent results of operations of Hilltop and SWS. As a holder of our common stock following the merger, you would be subject to the risks and liabilities affecting SWS as well as those of Hilltop.

*The merger is subject to the receipt of consents and approvals from government entities that may take longer than expected or may impose conditions that are not presently anticipated or that could have an adverse effect on the combined company following the merger.*

The merger is conditioned on the receipt of all requisite governmental and regulatory authorizations, consents, orders and approvals from the Federal Reserve Board and the Texas Department of Banking. These government entities may impose conditions on the completion of the merger and the merger of SWS's wholly owned bank subsidiary, Southwest Securities, FSB, with and into the Bank (the bank merger) or require changes to the terms of the merger or bank merger. Although we do not currently expect that any such material conditions or changes would be imposed, there can be no assurance that they will not be, and such conditions or changes could have the effect of delaying or preventing completion of the merger or imposing additional costs on or limiting the revenues of the combined company following the merger and the bank merger, any of which might have an adverse effect on the combined company following the merger and the bank merger.

*We are subject to contractual restrictions while the merger is pending.*

Uncertainty about the effect of the merger on employees and customers may have an adverse effect on SWS and consequently on us. These uncertainties may impair SWS's ability to attract, retain and motivate key personnel while the merger is pending, and could cause customers and others that deal with SWS to seek to change existing business relationships with SWS. Retention of certain employees may be challenging during the pendency of the merger, as certain employees may experience uncertainty about their future roles. If key employees depart because of issues relating to such uncertainty or a desire not to remain with the business, our business following the merger could be negatively impacted.

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In addition, the merger agreement restricts SWS and, to a lesser extent, us from taking certain specified actions until the merger occurs without the consent of the other party. These restrictions may prevent us from pursuing attractive business opportunities that may arise prior to the completion of the merger. In addition, our business may be indirectly adversely affected by the failure to pursue other beneficial opportunities due to the focus of management on the merger.

***The merger is subject to certain closing conditions that, if not satisfied or waived, will result in the merger not being completed, which may cause the price of our common stock to decline.***

The merger is subject to customary conditions to closing, including the receipt of required regulatory approvals and approval of the SWS stockholders. If any condition to the merger is not satisfied or waived, the merger will not be completed. In addition, we and SWS may terminate the merger agreement under certain circumstances even if the merger is approved by SWS stockholders, including if the merger has not been consummated by March 31, 2015. If we do not complete the merger, the trading price of our common stock may decline to the extent that the current prices reflect a market assumption that the merger will be completed. In addition, we would not realize any of the expected benefits of having completed the merger. If the merger is not completed, additional risks could materialize, which could materially and adversely affect our business, financial condition and results of operations. For example, our business may have been impacted adversely by the failure to pursue other beneficial opportunities due to the focus of management on the merger, without realizing any of the anticipated benefits of completing the merger. A termination of the merger agreement may also damage our reputation and franchise value.

***Our current stockholders will have a reduced ownership and voting interest after the merger and will exercise less influence over management.***

Our current stockholders have the right to vote in the election of our board of directors and on other matters affecting Hilltop. Immediately after the merger is completed, it is expected that, on a fully diluted basis, our current stockholders will own approximately 90%, and current SWS stockholders will own approximately 10%, of the outstanding shares of our common stock. As a result of the merger, our current stockholders will have less influence on our management and policies post-merger than they currently have, and current SWS stockholders will have less influence on our management and policies post-merger than they currently have with respect to SWS.

***The completion of the merger may trigger change in control provisions in certain agreements to which SWS is a party.***

The completion of the merger may trigger change in control provisions in certain agreements to which SWS is a party. If we and/or SWS are unable to negotiate waivers of those provisions, the counterparties may exercise their rights and remedies under the agreements (including terminating the agreements or seeking monetary penalties). Even if we and/or SWS are able to obtain waivers, the counterparties may demand a fee for such waivers or seek to renegotiate the agreements on materially less favorable terms than those currently in place.

***The combined company expects to incur substantial expenses related to the merger.***

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The combined company expects to incur substantial expenses in connection with completing the merger and combining the business, operations, networks, systems, technologies, policies and procedures of the two companies. Although we have assumed that a certain level of transaction and combination expenses would be incurred, there are a number of factors beyond our control that could affect the total amount or the timing of our and SWS's combination expenses. Many of the expenses that will be incurred, by their nature, are difficult to estimate accurately at the present time. Due to these factors, the transaction and combination expenses associated with the merger could, particularly in the near term, exceed the savings that the combined company expects to achieve from the elimination of duplicative expenses and the realization of economies of scale and cost savings related to the combination of the businesses following the completion of the merger. As a result of these expenses, we and SWS expect to take charges against earnings before and after the completion of the merger. The charges taken in connection with the merger are expected to be significant, although the aggregate amount and timing of such charges are uncertain at present. Further, if the merger is not completed, we would have to recognize these expenses without realizing the expected benefits of the merger.

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***If completed, the merger may not produce its anticipated results, and we may be unable to combine our operations with SWS's operations in the manner expected.***

We entered into the merger agreement with the expectation that the merger will result in various benefits. Achieving the anticipated benefits of the merger is subject to a number of uncertainties, including whether the Hilltop and SWS organizations can be combined in an efficient, effective and timely manner.

It is possible that the transition process could take longer than anticipated and could result in the loss of valuable employees, the disruption of each company's ongoing businesses, controls, procedures, policies and compensation arrangements, any of which could adversely affect the combined company's ability to achieve the anticipated benefits of the merger. The combined company's results of operations could also be adversely affected by any issues attributable to either company's operations that arise or are based on events or actions that occur prior to the closing of the merger. The companies may have difficulty addressing possible differences in corporate cultures and management philosophies. The transition process is subject to a number of uncertainties, and no assurance can be given that the anticipated benefits will be realized or, if realized, the timing of their realization. Failure to achieve these anticipated benefits could result in increased costs or decreases in the amount of expected revenues and could adversely affect the combined company's future business, financial condition, operating results and prospects.

***The merger may not be accretive to earnings and may cause dilution to our earnings per share, which may negatively affect the market price of our common stock.***

The merger may not be accretive to earnings and we could encounter additional transaction and integration-related costs, may fail to realize all of the benefits anticipated in the merger or be subject to other factors that affect preliminary estimates. Any of these factors could cause a decrease in our adjusted earnings per share or decrease or delay the expected accretive effect of the merger and contribute to a decrease in the price of our common stock.

***Pending litigation could result in an injunction preventing the completion of the merger or a judgment resulting in the payment of damages.***

In connection with the merger, purported SWS stockholders have filed putative shareholder class action lawsuits against SWS, the members of the SWS board of directors and Hilltop. Among other remedies, the plaintiffs seek to enjoin the merger. If the cases are not resolved, these lawsuits could prevent or delay completion of the merger and result in substantial costs to us and to SWS, including any costs associated with the indemnification of directors and officers. Plaintiffs may file additional lawsuits against SWS, Hilltop and/or the directors and officers of either company in connection with the merger. The defense or settlement of any lawsuit or claim that remains unresolved at the time the merger is completed may adversely affect our business, financial condition, results of operations and cash flows.

**Risks Related to Our Business**

***The impact of the changing regulatory capital requirements and new capital rules are uncertain.***

In July 2013, the Federal Reserve Board approved a final rule that will substantially amend the risk-based capital rules applicable to Hilltop and the Bank. The final rule implements the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios, which will be effective for Hilltop and the Bank on January 1, 2015, and refines the definition of what constitutes capital for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a capital conservation buffer of 2.5% above the new regulatory minimum capital ratios and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 to risk-based assets capital ratio of 8.5%; and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary



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bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions. The application of more stringent capital requirements for Hilltop and the Bank could, among other things, adversely affect our results of operations and growth, require the raising of additional capital, restrict our ability to pay dividends or repurchase shares and result in regulatory actions if we were to be unable to comply with such requirements.

In addition, the Federal Reserve Board adopted a final rule in February 2014 that clarifies how companies should incorporate the Basel III regulatory capital reforms into their capital and business projections during the 2014 and subsequent cycles of capital plan submissions and stress tests required under the Dodd-Frank Act. For companies and their subsidiary banks with between \$10.0 billion and \$50.0 billion in total consolidated assets, the initial stress testing cycle began on October 1, 2013 and the initial nine-quarter planning horizon for stress capital projections continues through the fourth quarter of 2015, which overlaps with the implementation of the Basel III capital reforms beginning on January 1, 2015. At June 30, 2014, Hilltop and the Bank had approximately \$9.4 billion and \$8.2 billion, respectively, in total consolidated assets and their average of total consolidated assets for the four most recent consecutive quarters was \$9.1 billion and \$8.1 billion, respectively. Accordingly, Hilltop and the Bank are not currently subject to capital planning and stress testing requirements. However, as a result of the merger, Hilltop would have more than \$10.0 billion in assets and would become subject to the stress testing requirements, which would likely increase our cost of regulatory compliance. Management continues to study the implementation of Basel III regulatory capital reforms and stress testing requirements.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On April 17, 2014, we issued an aggregate of 2,708 shares of common stock, under the Hilltop Holdings 2012 Equity Incentive Plan to certain non-employee directors as compensation for their service on our Board of Directors during the first quarter of 2014. The shares were issued pursuant to the exemption from registration under Section 4(a)(2) of the Securities Act.

**Item 6. Exhibits**

A list of exhibits filed herewith is contained in the Exhibit Index that immediately precedes such exhibits and is incorporated by reference herein.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**HILLTOP HOLDINGS INC.**

Date: July 30, 2014

By:

/s/ Darren Parmenter  
Darren Parmenter  
Executive Vice President    Principal Financial Officer  
(Principal Financial and Accounting Officer and duly  
authorized officer)

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**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description of Exhibit</b>  |
|---------------------------|--|
| 2.1                       | Agreement and Plan of Merger by and among SWS Group, Inc., Hilltop Holdings Inc. and Peruna LLC, dated as of March 31, 2014 (filed as Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed on April 1, 2014 (File No. 001-31987) and incorporated herein by reference).  |
| 2.2                       | Purchase and Assumption Agreement - Whole Bank, All Deposits, dated as of September 13, 2013, by and among the Federal Deposit Insurance Corporation, receiver of First National Bank, Edinburg, Texas, PlainsCapital Bank and the Federal Deposit Insurance Corporation (filed as Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed on September 19, 2013 (File No. 001-31987) and incorporated herein by reference).  |
| 3.1*                      | Articles of Amendment and Restatement of Affordable Residential Communities Inc., dated February 16, 2004, as amended or supplemented by: Articles Supplementary, dated February 16, 2004; Corporate Charter Certificate of Notice, dated June 6, 2005; Articles of Amendment, dated January 23, 2007; Articles of Amendment, dated July 31, 2007; Corporate Charter Certificate of Notice, dated September 23, 2008; Articles Supplementary, dated December 15, 2010; Articles Supplementary, dated as of November 29, 2012 relating to Subtitle 8 election; Articles Supplementary, dated November 29, 2012 relating to Non-Cumulative Perpetual Preferred Stock, Series B, of Hilltop Holdings Inc.; and Articles of Amendment, dated March 31, 2014. |
| 31.1*                     | Certification of Principal Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.  |
| 31.2*                     | Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.  |
| 32.1*                     | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101.INS                   | XBRL Instance Document   |
| 101.SCH                   | XBRL Taxonomy Extension Schema   |
| 101.CAL                   | XBRL Taxonomy Extension Calculation Linkbase   |
| 101.DEF                   | XBRL Taxonomy Extension Definition Linkbase  |
| 101.LAB                   | XBRL Taxonomy Extension Label Linkbase   |
| 101.PRE                   | XBRL Taxonomy Extension Presentation Linkbase  |

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\* Filed herewith.