

Hilltop Holdings Inc.
Form 10-Q
April 25, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2017

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

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Dallas, TX

(Address of principal executive offices)

75201

(Zip Code)

(214) 855-2177

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 April 25, 2017 was 98,529,976.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2017

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(Unaudited)

	March 31, 2017	December 31, 2016
Assets		
Cash and due from banks	\$ 545,928	\$ 669,357
Federal funds sold	24,404	21,407
Securities purchased under agreements to resell	113,228	89,430
Assets segregated for regulatory purposes	166,395	180,993
Securities:		
Trading, at fair value	373,300	265,534
Available for sale, at fair value (amortized cost of \$755,290 and \$598,198, respectively)	755,546	598,007
Held to maturity, at amortized cost (fair value of \$331,387 and \$345,088, respectively)	337,357	351,831
	1,466,203	1,215,372
Loans held for sale	1,329,493	1,795,463
Non-covered loans, net of unearned income	5,783,853	5,843,499
Allowance for non-covered loan losses	(55,157)	(54,186)
Non-covered loans, net	5,728,696	5,789,313
Covered loans, net of allowance of \$753 and \$413, respectively	234,681	255,714
Broker-dealer and clearing organization receivables	1,574,031	1,497,741
Premises and equipment, net	184,091	190,361
FDIC indemnification asset	47,940	71,313
Covered other real estate owned	45,374	51,642
Other assets	583,554	613,453
Goodwill	251,808	251,808
Other intangible assets, net	42,601	44,695
Total assets	\$ 12,338,427	\$ 12,738,062
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	\$ 2,272,905	\$ 2,199,483
Interest-bearing	5,056,957	4,864,328
Total deposits	7,329,862	7,063,811

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Broker-dealer and clearing organization payables	1,437,548	1,347,128
Short-term borrowings	753,777	1,417,289
Securities sold, not yet purchased, at fair value	144,193	153,889
Notes payable	324,701	317,912
Junior subordinated debentures	67,012	67,012
Other liabilities	392,025	496,501
Total liabilities	10,449,118	10,863,542
Commitments and contingencies (see Notes 12 and 13)		
Stockholders' equity:		
Hilltop stockholders' equity:		
Common stock, \$0.01 par value, 125,000,000 shares authorized; 98,407,385 and 98,543,774 shares issued and outstanding, respectively	984	985
Additional paid-in capital	1,570,329	1,572,877
Accumulated other comprehensive income	897	485
Retained earnings	313,197	295,568
Deferred compensation employee stock trust, net	893	903
Employee stock trust (15,057 and 15,492 shares, at cost, respectively)	(300)	(309)
Total Hilltop stockholders' equity	1,886,000	1,870,509
Noncontrolling interests	3,309	4,011
Total stockholders' equity	1,889,309	1,874,520
Total liabilities and stockholders' equity	\$ 12,338,427	\$ 12,738,062

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended March 31,	
	2017	2016
Interest income:		
Loans, including fees	\$ 89,991	\$ 91,533
Securities borrowed	8,053	7,589
Securities:		
Taxable	7,027	6,367
Tax-exempt	1,244	1,637
Other	1,926	1,028
Total interest income	108,241	108,154
Interest expense:		
Deposits	4,690	3,839
Securities loaned	6,340	5,987
Short-term borrowings	1,418	1,085
Notes payable	2,814	2,582
Junior subordinated debentures	711	645
Other	168	176
Total interest expense	16,141	14,314
Net interest income	92,100	93,840
Provision for loan losses	1,705	3,407
Net interest income after provision for loan losses	90,395	90,433
Noninterest income:		
Net realized gains on securities	—	46
Net gains from sale of loans and other mortgage production income	124,150	127,297
Mortgage loan origination fees	19,556	18,813
Securities commissions and fees	39,057	38,317
Investment and securities advisory fees and commissions	22,202	23,819
Net insurance premiums earned	36,140	39,733
Other	30,334	29,350
Total noninterest income	271,439	277,375
Noninterest expense:		
Employees' compensation and benefits	186,559	182,761
Occupancy and equipment, net	27,293	27,833

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Loss and loss adjustment expenses	21,700	21,959
Policy acquisition and other underwriting expenses	11,229	11,252
Other	73,711	81,384
Total noninterest expense	320,492	325,189
Income before income taxes	41,342	42,619
Income tax expense	15,035	14,423
Net income	26,307	28,196
Less: Net income (loss) attributable to noncontrolling interest	(127)	629
Income attributable to Hilltop	\$ 26,434	\$ 27,567
Earnings per common share:		
Basic	\$ 0.27	\$ 0.28
Diluted	\$ 0.27	\$ 0.28
Cash dividends declared per common share	\$ 0.06	\$ —
Weighted average share information:		
Basic	98,441	98,153
Diluted	98,757	98,669

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended March 31,	
	2017	2016
Net income	\$ 26,307	\$ 28,196
Other comprehensive income:		
Net unrealized gains on securities available for sale, net of tax of \$231 and \$2,390, respectively	412	4,279
Reclassification adjustment for gains included in net income, net of tax of \$0 and \$(16), respectively	—	(30)
Comprehensive income	26,719	32,445
Less: comprehensive income (loss) attributable to noncontrolling interest	(127)	629
Comprehensive income applicable to Hilltop	\$ 26,846	\$ 31,816

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(in thousands)

(Unaudited)

		Additional	Accumulated		Deferred	Employee		Total		
Common Stock		Paid-in	Other	Comprehensive	Compensation	Stock Trust		Hilltop	Noncontrolling	
Shares	Amount	Capital	Income	Earnings	Employee Stock Trust, Net	Shares	Amount	Stockholders' Equity	Interest	Interest
1,98,896	\$ 989	\$ 1,577,270	\$ 2,629	\$ 155,475	\$ 1,034	22	\$ (443)	\$ 1,736,954	\$ 1,171	\$ 1,171
—	—	—	—	27,567	—	—	—	27,567	629	629
ve	—	—	4,249	—	—	—	—	4,249	—	—
ck 500	5	3,845	—	—	—	—	—	3,850	—	—
n	—	2,228	—	—	—	—	—	2,228	—	—
ck ard	6	108	—	—	—	—	—	108	—	—
ck	(1)	(33)	—	—	—	—	—	(33)	—	—
of ck	(816)	(16,268)	—	—	—	—	—	(16,276)	—	—
n	—	—	—	—	(14)	(1)	15	1	—	—
o ng	—	—	—	—	—	—	—	—	(437)	(437)
	98,585	\$ 986	\$ 1,567,150	\$ 6,878	\$ 183,042	\$ 1,020	21	\$ (428)	\$ 1,758,648	\$ 1,363

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98,544	\$ 985	\$ 1,572,877	\$ 485	\$ 295,568	\$ 903	15	\$ (309)	\$ 1,870,509	\$ 4,011	\$
—	—	—	—	26,434	—	—	—	26,434	(127)	
—	—	—	412	—	—	—	—	412	—	
—	—	2,577	—	—	—	—	—	2,577	—	
3	—	105	—	—	—	—	—	105	—	
122	2	(1,031)	—	—	—	—	—	(1,029)	—	
(262)	(3)	(4,199)	—	(3,003)	—	—	—	(7,205)	—	
—	—	—	—	(5,802)	—	—	—	(5,802)	—	
—	—	—	—	—	(10)	—	9	(1)	—	
—	—	—	—	—	—	—	—	—	(575)	
98,407	\$ 984	\$ 1,570,329	\$ 897	\$ 313,197	\$ 893	15	\$ (300)	\$ 1,886,000	\$ 3,309	\$

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Three Months Ended March 31,	
	2017	2016
Operating Activities		
Net income	\$ 26,307	\$ 28,196
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,705	3,407
Depreciation, amortization and accretion, net	(1,031)	(11,830)
Net realized gains on securities	—	(46)
Deferred income taxes	1,531	494
Other, net	1,990	8,320
Net change in securities purchased under agreements to resell	(23,798)	9,014
Net change in assets segregated for regulatory purposes	14,598	37,899
Net change in trading securities	(107,766)	(154,279)
Net change in broker-dealer and clearing organization receivables	(39,422)	130,858
Net change in FDIC indemnification asset	19,424	11,214
Net change in other assets	(8,702)	(50,550)
Net change in broker-dealer and clearing organization payables	110,694	(162,722)
Net change in other liabilities	(104,858)	(48,283)
Net change in securities sold, not yet purchased	(9,696)	35,660
Proceeds from sale of mortgage servicing rights asset	17,499	—
Net gains from sales of loans	(124,150)	(127,297)
Loans originated for sale	(2,939,349)	(3,052,579)
Proceeds from loans sold	3,514,340	3,352,409
Net cash provided by operating activities	349,316	9,885
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	15,152	21,398
Proceeds from sales, maturities and principal reductions of securities available for sale	83,048	64,918
Purchases of securities held to maturity	(831)	—
Purchases of securities available for sale	(240,757)	(51,531)
Net change in loans	57,902	(233,309)
Purchases of premises and equipment and other assets	(4,951)	(9,948)
Proceeds from sales of premises and equipment and other real estate owned	11,438	22,068
Net cash paid for Federal Home Loan Bank and Federal Reserve Bank stock	34,953	12,311
Net cash used in investing activities	(44,046)	(174,093)

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Financing Activities		
Net change in deposits	245,777	139,925
Net change in short-term borrowings	(663,512)	(114,452)
Proceeds from notes payable	72,382	5,553
Payments on notes payable	(65,573)	(12,028)
Proceeds from issuance of common stock	—	3,850
Payments to repurchase common stock	(7,205)	—
Dividends paid on common stock	(5,802)	—
Net cash distributed to noncontrolling interest	(575)	(437)
Taxes paid on employee stock awards netting activity	(838)	(33)
Other, net	(356)	(106)
Net cash provided by (used in) financing activities	(425,702)	22,272
Net change in cash and cash equivalents	(120,432)	(141,936)
Cash and cash equivalents, beginning of period	690,764	669,445
Cash and cash equivalents, end of period	\$ 570,332	\$ 527,509
Supplemental Disclosures of Cash Flow Information		
Cash paid for interest	\$ 14,407	\$ 16,377
Cash paid for income taxes, net of refunds	\$ 1,262	\$ 831
Supplemental Schedule of Non-Cash Activities		
Conversion of loans to other real estate owned	\$ 1,945	\$ 4,726
Additions to mortgage servicing rights	\$ 1,224	\$ 1,639

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. The Company’s primary line of business is to provide business and consumer banking services from offices located throughout Texas through PlainsCapital Bank (the “Bank”). In addition, the Company provides an array of financial products and services through its broker-dealer, mortgage origination and insurance subsidiaries.

The Company provides its products and services through three primary business units, PlainsCapital Corporation (“PCC”), Hilltop Securities Holdings LLC (“Securities Holdings”) and National Lloyds Corporation (“NLC”). PCC is a financial holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, traditional banking, wealth and investment management and treasury management services primarily in Texas and residential mortgage lending throughout the United States. Securities Holdings is a holding company, headquartered in Dallas, Texas, that provides, through its subsidiaries, investment banking and other related financial services, including municipal advisory, sales, trading and underwriting of taxable and tax-exempt fixed income securities, equity trading, clearing, securities lending, structured finance and retail brokerage services throughout the United States. NLC is a property and casualty insurance holding company, headquartered in Waco, Texas, 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.

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, 2016 (“2016 Form 10-K”). Results for

interim periods are not necessarily indicative of results to be expected for a full year or any future period.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates regarding the allowance for loan losses, the fair values of financial instruments, the amounts receivable from the Federal Deposit Insurance Corporation (the “FDIC”) under loss-share agreements (the “FDIC Indemnification Asset”), reserves for losses and loss adjustment expenses (“LAE”), 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.

Hilltop owns 100% of the outstanding stock of PCC. PCC 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”).

PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC (“Ventures Management”). Ventures Management is the managing member and owns 51% of the membership interest in both PrimeLending Ventures, LLC (“Ventures”) and Mutual of Omaha Mortgage, LLC.

PCC 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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Subsections of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”), because the primary beneficiaries of the Trusts are not within the consolidated group.

Hilltop has a 100% membership interest in Securities Holdings, which operates through its wholly-owned subsidiaries, Hilltop Securities Inc. (“Hilltop Securities”), Hilltop Securities Independent Network Inc. (“HTS Independent Network”) (collectively, the “Hilltop Broker-Dealers”) and First Southwest Asset Management, LLC. Hilltop Securities is a broker-dealer registered with the Securities and Exchange Commission (the “SEC”) and Financial Industry Regulatory Authority (“FINRA”) and a member of the New York Stock Exchange (“NYSE”), HTS Independent Network is an introducing broker-dealer that is also registered with the SEC and FINRA, and First Southwest Asset Management, LLC is a registered investment adviser under the Investment Advisers Act of 1940.

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

The consolidated financial statements include the accounts of the above-named entities. 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 ASC.

Certain reclassifications have been made to the prior period consolidated financial statements to conform with the current period presentation. In preparing these consolidated financial statements, subsequent events were evaluated through the time the financial statements were issued. Financial statements are considered issued when they are widely distributed to all stockholders and other financial statement users, or filed with the SEC.

2. Recently Issued Accounting Standards

In April 2017, FASB issued ASU 2017-08 which shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. The amendment is effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2018, using the modified retrospective transaction method. As permitted within the amendment, the Company elected to early adopt and apply the provisions of this amendment as of January 1, 2017. This adoption had no effect on the Company's consolidated financial statements.

In January 2017, FASB issued ASU 2017-01 which provides guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendment is effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2017, using the prospective method. Early adoption is permitted. Adoption of the amendment is not expected to have a significant effect on the Company's consolidated financial statements.

In October 2016, FASB issued ASU No. 2016-16 which addresses improvement in accounting for income tax consequences of intra-equity transfers of assets other than inventory. The amendment requires that an entity recognize the income tax consequences of the intra-equity transfer of an asset other than inventory when the transfer occurs. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2017, using the modified retrospective transaction method. Early adoption is permitted. The Company does not intend to adopt the provisions of the amendment early and does not expect such provisions to have a significant effect on the Company's consolidated financial statements.

In August 2016, FASB issued ASU 2016-15 to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows and to eliminate the diversity in practice related to such classifications. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2017 using a retrospective transition method. Early adoption is permitted. The Company does not intend to adopt the provisions of the amendment early and does not expect such provisions to have a significant effect on the Company's consolidated financial statements.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

In June 2016, FASB issued ASU 2016-13 which sets forth a “current expected credit loss” (CECL) model which requires entities to measure all credit losses expected over the life of an exposure (or pool of exposures) for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost and applies to some off-balance sheet credit exposures. The amendment also requires enhanced disclosures to help financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an entity’s portfolio. The amendments are effective for annual periods, and interim reporting periods within those annual periods, beginning after December 15, 2019 with a cumulative-effect adjustment to retained earnings as of the beginning of the reporting period of adoption. Although the Company does not intend to adopt the provisions of the amendment early. A cross-functional team is evaluating the provisions of the amendment and the impact on its future consolidated financial statements through the identification of data requirements and determination of necessary modifications to its existing credit loss model and processes. The extent of the change in allowance for loan losses will be impacted by the portfolio composition and quality at the adoption date as well as economic conditions and forecasts at that time.

In February 2016, FASB issued ASU 2016-02 related to leases. The new standard is intended to increase transparency and comparability among organizations and require lessees to record a right-to-use asset and liability representing the obligation to make lease payments for long-term leases. Accounting by lessors will remain largely unchanged. The amendments are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early adoption is permitted. Adoption will require a modified retrospective transition where the lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented. The Company does not intend to adopt the provisions of the amendment early. The Company is currently evaluating the provisions of the amendment on its consolidated financial statements, but upon adoption, expects to report higher assets and liabilities as a result of including additional leases on the consolidated balance sheets.

In January 2016, FASB issued ASU 2016-01 related to financial instruments. This amendment requires that most equity investments be measured at fair value, with subsequent changes in fair value recognized in net income. The amendment also impacts financial liabilities under the Fair Value Option and the presentation and disclosure requirements for financial instruments. The amendment is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Adoption of the amendment is not expected to have a significant effect on the Company’s consolidated financial statements.

In July 2015, the FASB issued ASU 2015-14, which deferred the effective date of ASU 2014-09 by one year, to clarify 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, 2017 and may be adopted using either a full retrospective transition method or a modified, cumulative-effect approach wherein the guidance is applied only to existing contracts as of the date of initial application and to new contracts entered into thereafter. The Company does not intend to adopt the provisions of the amendment early and expects to adopt using the cumulative-effect approach. The Company is currently in the process of gathering an inventory of contracts with customers and performing an in-depth assessment. The preliminary assessment suggests that the revenue recognition policies within the Company's broker-dealer and banking segments are most likely to be effected when adopted. However, there are many aspects of this new accounting guidance that are still being interpreted to clarify and address certain implementation issues. The Company will continue to evaluate the impact on its future consolidated financial statements of both current and newly issued guidance associated with the amendment.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

3. Fair Value Measurements

Fair Value Measurements and Disclosures

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

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

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

Fair Value Option

The Company has elected to measure substantially all of PrimeLending's mortgage loans held for sale and retained mortgage servicing rights ("MSR") asset 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. At March 31, 2017 and December 31, 2016, the aggregate fair value of PrimeLending's mortgage loans held for sale accounted for under the Fair Value Option was \$1.27 billion and \$1.75 billion, respectively, and the unpaid principal balance of those loans was \$1.22 billion and \$1.71 billion, respectively. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Level 1	Level 2	Level 3	Total
	Inputs	Inputs	Inputs	Fair Value
March 31, 2017				
Trading securities	\$ 3,640	\$ 369,660	\$ —	\$ 373,300
Available for sale securities	20,263	735,283	—	755,546
Loans held for sale	—	1,244,018	30,214	1,274,232
Derivative assets	—	72,906	—	72,906
MSR asset	—	—	45,573	45,573
Securities sold, not yet purchased	75,047	69,146	—	144,193
Derivative liabilities	—	37,024	—	37,024

	Level 1	Level 2	Level 3	Total
	Inputs	Inputs	Inputs	Fair Value
December 31, 2016				
Trading securities	\$ 9,481	\$ 256,053	\$ —	\$ 265,534
Available for sale securities	19,840	578,167	—	598,007
Loans held for sale	—	1,712,697	35,801	1,748,498
Derivative assets	—	57,036	—	57,036
MSR asset	—	—	61,968	61,968
Securities sold, not yet purchased	60,715	93,174	—	153,889
Derivative liabilities	—	35,737	—	35,737

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

	Balance at			Total Gains or Losses		
	Beginning of	Purchases/	Sales/	(Realized or Unrealized)	Included in Other	Balance at
	Period	Additions	Reductions	Included in	Comprehensive	End of Period
				Net Income	Income (Loss)	
Three months ended March 31, 2017						
Loans held for sale	\$ 35,801	\$ 7,828	\$ (10,701)	\$ (2,714)	\$ —	\$ 30,214

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MSR asset	61,968	1,224	(17,499)	(120)	—	45,573
Total	\$ 97,769	\$ 9,052	\$ (28,200)	\$ (2,834)	\$ —	\$ 75,787

Three months
ended March 31, 2016

Trading securities	\$ 1	\$ —	\$ —	\$ —	\$ —	\$ 1
Loans held for sale	25,880	23,236	(4,237)	(4,334)	—	40,545
MSR asset	52,285	1,639	—	(14,061)	—	39,863
Total	\$ 78,166	\$ 24,875	\$ (4,237)	\$ (18,395)	\$ —	\$ 80,409

All net realized and unrealized gains (losses) in the table above are reflected in the accompanying consolidated financial statements. Excluding the trading securities sold during the three months ended September 30, 2016, the unrealized gains (losses) relate to financial instruments still held at March 31, 2017.

For Level 3 financial instruments measured at fair value on a recurring basis at March 31, 2017, the significant unobservable inputs used in the fair value measurements were as follows.

Financial instrument	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
Loans held for sale	Discounted cash flows / Market comparable	Projected price	88 - 97 % (96 %)
MSR asset	Discounted cash flows	Constant prepayment rate	10.45 %
		Discount rate	11.14 %

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

The fair value of certain loans held for sale that cannot be sold through normal sale channels or are non-performing is measured using Level 3, or unobservable, inputs. The fair value of such loans is generally based upon estimates of expected cash flows using unobservable inputs, including listing prices of comparable assets, uncorroborated expert opinions, and/or management's knowledge of underlying collateral.

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

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

The following tables present those changes in fair value of instruments recognized in the consolidated statements of operations that are accounted for under the Fair Value Option (in thousands).

	Three Months Ended March 31, 2017			Three Months Ended March 31, 2016		
	Net	Other	Total	Net	Other	Total
	Gains	Noninterest	Changes in	Gains (Losses)	Noninterest	Changes in
	(Losses)	Income	Fair Value	(Losses)	Income	Fair Value
Loans held for sale	\$ 8,862	\$ —	\$ 8,862	\$ 447	\$ —	\$ 447
MSR asset	(120)	—	(120)	(14,061)	—	(14,061)

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. PCI loans with a fair value of \$172.9 million, \$822.8 million

and \$73.5 million were acquired by the Company upon completion of the merger with PCC (the “PlainsCapital Merger”), the FDIC-assisted transaction whereby the Bank acquired certain assets and assumed certain liabilities of Edinburg, Texas-based First National Bank (“FNB”) on September 13, 2013 (the “FNB Transaction”), and the acquisition of SWS Group, Inc. (“SWS”) in a stock and cash transaction (the “SWS Merger”), whereby SWS’s banking subsidiary, Southwest Securities, FSB was merged into the Bank, respectively (collectively, the “Bank Transactions”). 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 on acquired loans accounted for in pools (“Pooled Loans”), and estimated collateral values.

At March 31, 2017, estimates for these significant unobservable inputs were as follows.

	PCI Loans					
	PlainsCapital Merger		FNB Transaction		SWS Merger	
Weighted average default rate	53	%	49	%	55	%
Weighted average loss severity rate	61	%	23	%	29	%
Weighted average prepayment speed	0	%	8	%	0	%

At March 31, 2017, the resulting weighted average expected loss on PCI loans associated with the PlainsCapital Merger, FNB Transaction and SWS Merger was 32%, 11% and 16%, respectively.

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 orders an updated appraisal of the fair value of the collateral. Because the Company obtains updated appraisals when evidence of a decline in the fair value of collateral exists, it typically does not adjust appraised values.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Other Real Estate Owned — The Company determines fair value primarily using independent appraisals of other real estate owned (“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 March 31, 2017, 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. Level 3 inputs were used to determine the initial fair value at acquisition 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 March 31, 2017 and December 31, 2016, the estimated fair value of covered OREO was \$45.4 million and \$51.6 million, respectively, and the underlying fair value measurements utilized Level 2 and Level 3 inputs. The fair value of non-covered OREO at March 31, 2017 and December 31, 2016 was \$4.6 million and \$4.5 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 subsequent to initial recognition 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	Level 2	Level 3	Total	Total Gains (Losses) for the	
	Inputs	Inputs	Inputs	Fair Value	Three Months Ended March	
March 31, 2017					2017	2016
Non-covered impaired loans	\$ —	\$ —	\$ 47,054	\$ 47,054	\$ (196)	\$ (33)
Covered impaired loans	—	—	41,777	41,777	(366)	332
Non-covered other real estate owned	—	2,894	—	2,894	(15)	—
Covered other real estate owned	—	3,762	—	3,762	(1,192)	(9,765)

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 the Company’s 2016 Form 10-K.

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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).

March 31, 2017	Carrying Amount	Estimated Fair Value			Total
		Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	
Financial assets:					
Cash and cash equivalents	\$ 570,332	\$ 570,332	\$ —	\$ —	\$ 570,332
Securities purchased under agreements to resell	113,228	—	113,228	—	113,228
Assets segregated for regulatory purposes	166,395	166,395	—	—	166,395
Held to maturity securities	337,357	—	331,387	—	331,387
Loans held for sale	55,261	—	55,261	—	55,261
Non-covered loans, net	5,728,696	—	465,209	5,414,146	5,879,355
Covered loans, net	234,681	—	—	344,113	344,113
Broker-dealer and clearing organization receivables	1,574,031	—	1,574,031	—	1,574,031
FDIC indemnification asset	47,940	—	—	36,308	36,308
Other assets	63,558	—	57,983	5,575	63,558
Financial liabilities:					
Deposits	7,329,862	—	7,323,110	—	7,323,110
Broker-dealer and clearing organization payables	1,437,548	—	1,437,548	—	1,437,548
Short-term borrowings	753,777	—	753,777	—	753,777
Debt	391,713	—	385,681	—	385,681
Other liabilities	5,436	—	5,436	—	5,436

December 31, 2016	Carrying Amount	Estimated Fair Value			Total
		Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	
Financial assets:					
Cash and cash equivalents	\$ 690,764	\$ 690,764	\$ —	\$ —	\$ 690,764
Securities purchased under agreements to resell	89,430	—	89,430	—	89,430

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Assets segregated for regulatory purposes	180,993	180,993	—	—	180,993
Held to maturity securities	351,831	—	345,088	—	345,088
Loans held for sale	46,965	—	46,965	—	46,965
Non-covered loans, net	5,789,313	—	502,077	5,459,975	5,962,052
Covered loans, net	255,714	—	—	367,444	367,444
Broker-dealer and clearing organization receivables	1,497,741	—	1,497,741	—	1,497,741
FDIC indemnification asset	71,313	—	—	60,173	60,173
Other assets	62,904	—	58,697	4,207	62,904
Financial liabilities:					
Deposits	7,063,811	—	7,058,837	—	7,058,837
Broker-dealer and clearing organization payables	1,347,128	—	1,347,128	—	1,347,128
Short-term borrowings	1,417,289	—	1,417,289	—	1,417,289
Debt	384,924	—	378,822	—	378,822
Other liabilities	3,708	—	3,708	—	3,708

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

4. Securities

The fair value of trading securities is summarized as follows (in thousands).

	March 31, 2017	December 31, 2016
U.S. Treasury securities	\$ 314	\$ 5,940
U.S. government agencies:		
Bonds	51,586	36,303
Residential mortgage-backed securities	150,233	2,539
Commercial mortgage-backed securities	14,978	15,171
Collateralized mortgage obligations	1,353	5,607
Corporate debt securities	69,768	60,699
States and political subdivisions	66,274	89,946
Unit investment trusts	11,603	41,409
Private-label securitized product	3,849	4,292
Other	3,342	3,628
Totals	\$ 373,300	\$ 265,534

The Hilltop Broker-Dealers enter into transactions that represent commitments to purchase and deliver securities at prevailing future market prices to facilitate customer transactions and satisfy such commitments. Accordingly, the Hilltop Broker-Dealers' ultimate obligation may exceed the amount recognized in the financial statements. These securities, which are carried at fair value and reported as securities sold, not yet purchased in the consolidated balance sheets, had a value of \$144.2 million and \$153.9 million at March 31, 2017 and December 31, 2016, respectively.

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

March 31, 2017	Available for Sale			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	

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U.S. Treasury securities	\$ 101,683	\$ 156	\$ (44)	\$ 101,795
U.S. government agencies:				
Bonds	100,984	857	(167)	101,674
Residential mortgage-backed securities	211,934	757	(3,018)	209,673
Commercial mortgage-backed securities	8,719	1	(40)	8,680
Collateralized mortgage obligations	157,656	31	(3,243)	154,444
Corporate debt securities	76,076	2,421	(40)	78,457
States and political subdivisions	78,644	1,635	(229)	80,050
Commercial mortgage-backed securities	499	11	—	510
Equity securities	19,095	1,243	(75)	20,263
Totals	\$ 755,290	\$ 7,112	\$ (6,856)	\$ 755,546

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

	Available for Sale			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
December 31, 2016				
U.S. Treasury securities	\$ 31,701	\$ 144	\$ (44)	\$ 31,801
U.S. government agencies:				
Bonds	121,838	881	(67)	122,652
Residential mortgage-backed securities	135,371	708	(2,941)	133,138
Commercial mortgage-backed securities	8,771	2	(58)	8,715
Collateralized mortgage obligations	117,879	29	(3,206)	114,702
Corporate debt securities	76,866	2,354	(91)	79,129
States and political subdivisions	86,353	1,498	(336)	87,515
Commercial mortgage-backed securities	499	16	—	515
Equity securities	18,920	1,263	(343)	19,840
Totals	\$ 598,198	\$ 6,895	\$ (7,086)	\$ 598,007
	Held to Maturity			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
March 31, 2017				
U.S. government agencies:				
Bonds	\$ 40,513	\$ 6	\$ (1,192)	\$ 39,327
Residential mortgage-backed securities	18,717	128	(11)	18,834
Commercial mortgage-backed securities	31,604	102	(554)	31,152
Collateralized mortgage obligations	205,176	115	(3,077)	202,214
States and political subdivisions	41,347	130	(1,617)	39,860
Totals	\$ 337,357	\$ 481	\$ (6,451)	\$ 331,387
	Held to Maturity			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
December 31, 2016				
U.S. government agencies:				
Bonds	\$ 40,513	\$ —	\$ (1,287)	\$ 39,226
Residential mortgage-backed securities	19,606	13	(6)	19,613
Commercial mortgage-backed securities	31,767	102	(593)	31,276
Collateralized mortgage obligations	217,954	128	(3,372)	214,710
States and political subdivisions	41,991	70	(1,798)	40,263

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Totals	\$ 351,831	\$ 313	\$ (7,056)	\$ 345,088
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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Information regarding available for sale and held to maturity securities that were in an unrealized loss position is shown in the following tables (dollars in thousands).

	March 31, 2017			December 31, 2016		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Available for Sale						
U.S. treasury securities:						
Unrealized loss for less than twelve months	7	\$ 21,713	\$ 44	7	\$ 21,694	\$ 44
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	7	21,713	44	7	21,694	44
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	7	74,923	167	1	14,908	67
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	7	74,923	167	1	14,908	67
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	16	155,596	3,018	12	109,398	2,941
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	16	155,596	3,018	12	109,398	2,941
Commercial mortgage-backed securities:						
Unrealized loss for less than twelve months	2	7,100	40	2	7,127	58
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	2	7,100	40	2	7,127	58
Collateralized mortgage obligations:						
	17	124,634	2,332	11	91,144	2,340

Unrealized loss for less than twelve months						
Unrealized loss for twelve months or longer	8	17,895	911	8	19,320	866
	25	142,529	3,243	19	110,464	3,206
Corporate debt securities:						
Unrealized loss for less than twelve months	2	3,977	40	3	5,899	91
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	2	3,977	40	3	5,899	91
States and political subdivisions:						
Unrealized loss for less than twelve months	25	12,406	220	32	17,549	322
Unrealized loss for twelve months or longer	1	457	9	1	450	14
	26	12,863	229	33	17,999	336
Equity securities:						
Unrealized loss for less than twelve months	1	54	—	—	—	—
Unrealized loss for twelve months or longer	2	7,009	75	2	11,107	343
	3	7,063	75	2	11,107	343
Total available for sale:						
Unrealized loss for less than twelve months	77	400,403	5,861	68	267,719	5,863
Unrealized loss for twelve months or longer	11	25,361	995	11	30,877	1,223
	88	\$ 425,764	\$ 6,856	79	\$ 298,596	\$ 7,086

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

	March 31, 2017		Unrealized Losses	December 31, 2016		Unrealized Losses
	Number of Securities	Fair Value		Number of Securities	Fair Value	
Held to Maturity						
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	4	\$ 33,321	\$ 1,192	4	\$ 33,225	\$ 1,287
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	4	33,321	1,192	4	33,225	1,287
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	1	6,131	11	2	13,178	6
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	1	6,131	11	2	13,178	6
Commercial mortgage-backed securities:						
Unrealized loss for less than twelve months	4	19,801	549	5	18,891	588
Unrealized loss for twelve months or longer	1	1,395	5	1	1,401	5
	5	21,196	554	6	20,292	593
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	18	169,154	3,077	19	187,669	3,372
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	18	169,154	3,077	19	187,669	3,372
States and political subdivisions:						
Unrealized loss for less than twelve months	60	25,088	1,611	71	29,862	1,790
Unrealized loss for twelve months or longer	1	461	6	1	462	8

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	61	25,549	1,617	72	30,324	1,798
Total held to maturity:						
Unrealized loss for less than twelve months	87	253,495	6,440	101	282,825	7,043
Unrealized loss for twelve months or longer	2	1,856	11	2	1,863	13
	89	\$ 255,351	\$ 6,451	103	\$ 284,688	\$ 7,056

During the three months ended March 31, 2017 and 2016, the Company did not record any other-than-temporary impairments (“OTTI”). Factors considered in the Company’s analysis include the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the Company’s 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 recording any OTTI of the securities. The Company does not intend, nor does the Company believe that is it likely that the Company will be required, to sell these securities before the recovery of the cost basis.

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The amortized cost and fair value of securities, excluding trading and available for sale equity securities, at March 31, 2017 are shown by contractual maturity below (in thousands).

	Available for Sale Amortized		Held to Maturity Amortized	
	Cost	Fair Value	Cost	Fair Value
Due in one year or less	\$ 183,702	\$ 183,982	\$ 4,286	\$ 4,297
Due after one year through five years	96,478	98,454	3,325	3,348
Due after five years through ten years	45,582	47,102	26,290	25,618
Due after ten years	31,625	32,438	47,959	45,924
	357,387	361,976	81,860	79,187
Residential mortgage-backed securities	211,934	209,673	18,717	18,834
Collateralized mortgage obligations	157,656	154,444	205,176	202,214
Commercial mortgage-backed securities	9,218	9,190	31,604	31,152
	\$ 736,195	\$ 735,283	\$ 337,357	\$ 331,387

The Company realized net gains of \$5.9 million and \$5.7 million from its trading securities portfolio during the three months ended March 31, 2017 and 2016, respectively. In addition, the Hilltop Broker-Dealers realized net gains from

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

trading activities primarily associated with the structured finance business of \$6.6 million and \$5.6 million during the three months ended March 31, 2017 and 2016, respectively. All such realized net gains are recorded as a component of other noninterest income within the consolidated statements of operations.

Securities with a carrying amount of \$780.5 million and \$695.1 million (with a fair value of \$772.3 million and \$688.1 million, respectively) at March 31, 2017 and December 31, 2016, respectively, were pledged to secure public and trust deposits, federal funds purchased and securities sold under agreements to repurchase, and for other purposes as required or permitted by law. Substantially all of these pledged securities were included in our available for sale and held to maturity securities portfolios at March 31, 2017 and December 31, 2016.

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 both March 31, 2017 and December 31, 2016, NLC had investments on deposit in custody for various state insurance departments with aggregate carrying values of \$9.2 million.

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).

	March 31, 2017	December 31, 2016
Commercial and industrial	\$ 1,655,945	\$ 1,696,453
Real estate	2,852,245	2,816,767
Construction and land development	767,798	786,850

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Consumer	42,656	41,352
Broker-dealer (1)	465,209	502,077
	5,783,853	5,843,499
Allowance for non-covered loan losses	(55,157)	(54,186)
Total non-covered loans, net of allowance	\$ 5,728,696	\$ 5,789,313

(1) Represents margin loans to customers and correspondents associated with our broker-dealer segment operations.

In connection with the Bank Transactions, 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 non-covered PCI loans (in thousands).

	March 31, 2017	December 31, 2016
Carrying amount	\$ 47,765	\$ 51,432
Outstanding balance	63,716	67,988

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 13,116	\$ 17,744
Reclassifications from nonaccretable difference, net(1)	139	2,343
Accretion	(1,813)	(3,919)
Balance, end of period	\$ 11,442	\$ 16,168

(1) Reclassifications from nonaccretable difference are primarily due to net increases in expected cash flows in the quarterly recasts. Reclassifications to nonaccretable difference occur when accruing loans are moved to non-accrual and expected cash flows are no longer predictable and the accretable yield is eliminated.

The remaining nonaccretable difference for non-covered PCI loans was \$20.6 million and \$22.8 million at March 31, 2017 and December 31, 2016, respectively.

Impaired loans exhibit a clear indication that the borrower's cash flow may not be sufficient to meet principal and interest payments, which generally occurs 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 the following tables include loans accounted for on an individual basis, as well as acquired 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, segregated between those considered to be PCI loans and those without credit impairment at acquisition, are summarized by class in the following tables (in thousands).

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
March 31, 2017					
PCI					
Commercial and industrial:					
Secured	\$ 22,495	\$ 6,558	\$ 1,455	\$ 8,013	\$ 208
Unsecured	2,150	—	—	—	—
Real estate:					

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Secured by commercial properties	35,756	10,459	16,109	26,568	1,873
Secured by residential properties	13,256	8,414	1,779	10,193	181
Construction and land development:					
Residential construction loans	—	—	—	—	—
Commercial construction loans and land development	4,983	1,030	1,683	2,713	326
Consumer	2,839	—	278	278	65
Broker-dealer	—	—	—	—	—
	81,479	26,461	21,304	47,765	2,653
Non-PCI					
Commercial and industrial:					
Secured	10,880	7,607	1,452	9,059	778
Unsecured	817	778	—	778	—
Real estate:					
Secured by commercial properties	11,949	11,596	—	11,596	—
Secured by residential properties	1,334	1,074	—	1,074	—
Construction and land development:					
Residential construction loans	15	—	—	—	—
Commercial construction loans and land development	680	—	661	661	144
Consumer	228	223	—	223	—
Broker-dealer	—	—	—	—	—
	25,903	21,278	2,113	23,391	922
	\$ 107,382	\$ 47,739	\$ 23,417	\$ 71,156	\$ 3,575

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

December 31, 2016	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
PCI					
Commercial and industrial:					
Secured	\$ 25,354	\$ 3,234	\$ 5,438	\$ 8,672	\$ 557
Unsecured	—	—	—	—	—
Real estate:					
Secured by commercial properties	38,005	11,097	17,413	28,510	1,907
Secured by residential properties	13,606	7,401	3,088	10,489	200
Construction and land development:					
Residential construction loans	—	—	—	—	—
Commercial construction loans and land development	5,780	1,391	2,076	3,467	377
Consumer	3,223	237	57	294	56
Broker-dealer	—	—	—	—	—
	85,968	23,360	28,072	51,432	3,097
Non-PCI					
Commercial and industrial:					
Secured	6,311	3,313	1,372	4,685	115
Unsecured	946	925	—	925	—
Real estate:					
Secured by commercial properties	10,134	10,000	—	10,000	—
Secured by residential properties	1,344	1,116	—	1,116	—
Construction and land development:					
Residential construction loans	28	28	—	28	—
Commercial construction loans and land development	738	48	679	727	167
Consumer	246	244	—	244	—
Broker-dealer	—	—	—	—	—
	19,747	15,674	2,051	17,725	282
	\$ 105,715	\$ 39,034	\$ 30,123	\$ 69,157	\$ 3,379

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

	Three Months Ended March 31,	
	2017	2016
Commercial and industrial:		
Secured	\$ 15,215	\$ 26,155
Unsecured	852	41
Real estate:		
Secured by commercial properties	38,337	40,371
Secured by residential properties	11,436	12,524
Construction and land development:		
Residential construction loans	14	111
Commercial construction loans and land development	3,784	4,622
Consumer	520	655
Broker-dealer	—	—
	\$ 70,158	\$ 84,479

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	March 31, 2017	December 31, 2016
Commercial and industrial:		
Secured	\$ 12,712	\$ 8,590
Unsecured	778	925
Real estate:		
Secured by commercial properties	11,596	11,034
Secured by residential properties	1,074	1,197
Construction and land development:		
Residential construction loans	—	28
Commercial construction loans and land development	661	727
Consumer	223	244
Broker-dealer	—	—
	\$ 27,044	\$ 22,745

At March 31, 2017 and December 31, 2016, non-covered non-accrual loans included non-covered PCI loans of \$3.7 million and \$5.0 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, \$1.8 million and \$1.7 million of real estate loans secured by residential properties and classified as held for sale were in non-accrual status at March 31, 2017 and December 31, 2016, respectively.

Interest income, including recoveries and cash payments, recorded on non-covered impaired loans was \$0.3 million and \$0.1 million during the three months ended March 31, 2017 and 2016, respectively. Except as noted above, non-covered PCI loans are considered to be performing due to the application of the accretion method.

The Bank classifies loan modifications as TDRs when it concludes that it has both granted a concession to a debtor and that the debtor is experiencing financial difficulties. Loan modifications are typically structured to create affordable payments for the debtor and can be achieved in a variety of ways. The Bank modifies loans by reducing interest rates and/or lengthening loan amortization schedules. The Bank may also reconfigure 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Information regarding TDRs granted during the three months ended March 31, 2017 and 2016, respectively is shown in the following table (in thousands). At March 31, 2017 and December 31, 2016, the Bank had nominal unadvanced commitments to borrowers whose loans have been restructured in TDRs.

	Three Months Ended March 31, 2017			Three Months Ended March 31, 2016		
	Number of Loans	Balance at Extension	Balance at End of Period	Number of Loans	Balance at Extension	Balance at End of Period
Commercial and industrial:						
Secured	1	\$ 1,357	\$ 1,342	1	\$ 1,196	\$ 1,196
Unsecured	—	—	—	—	—	—
Real estate:						
Secured by commercial properties	1	1,481	1,470	—	—	—
Secured by residential properties	—	—	—	—	—	—
Construction and land development:						
Residential construction loans	—	—	—	—	—	—
Commercial construction loans and land development	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
Broker-dealer	—	—	—	—	—	—
	2	\$ 2,838	\$ 2,812	1	\$ 1,196	\$ 1,196

All of the non-covered loan modifications included in the table above involved payment term extensions. The Bank did not grant principal reductions on any restructured non-covered loans during the three months ended March 31, 2017 and 2016.

The following table presents information regarding TDRs granted during the twelve months preceding March 31, 2017 and 2016, respectively, for which a payment was at least 30 days past due (dollars in thousands).

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	Twelve Months Preceding March 31, 2017			Twelve Months Preceding March 31, 2016		
	Number of	Balance at	Balance at End of	Number of	Balance at	Balance at End of
	Loans	Extension	Period	Loans	Extension	Period
Commercial and industrial:						
Secured	—	\$ —	\$ —	—	\$ —	\$ —
Unsecured	—	—	—	—	—	—
Real estate:						
Secured by commercial properties	1	1,481	1,470	1	1,084	1,017
Secured by residential properties	—	—	—	—	—	—
Construction and land development:						
Residential construction loans	—	—	—	—	—	—
Commercial construction loans and land development	—	—	—	—	—	—
Consumer	—	—	—	—	—	—
Broker-dealer	—	—	—	—	—	—
	1	\$ 1,481	\$ 1,470	1	\$ 1,084	\$ 1,017

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans (Non-PCI) Past Due 90 Days or More
March 31, 2017								
Commercial and industrial:								
Secured	\$ 3,816	\$ 1,186	\$ 3,643	\$ 8,645	\$ 1,544,697	\$ 8,013	\$ 1,561,355	\$ 14
Unsecured	1,814	—	—	1,814	92,776	—	94,590	—
Real estate:								
Secured by commercial properties	5,489	54	78	5,621	2,025,795	26,568	2,057,984	—
Secured by residential properties	602	419	—	1,021	783,047	10,193	794,261	—
Construction and land development:								
Residential construction loans	—	—	—	—	136,354	—	136,354	—
Commercial construction loans and land development	24	—	661	685	628,046	2,713	631,444	—
Consumer	230	26	4	260	42,118	278	42,656	4
Broker-dealer	—	—	—	—	465,209	—	465,209	—
	\$ 11,975	\$ 1,685	\$ 4,386	\$ 18,046	\$ 5,718,042	\$ 47,765	\$ 5,783,853	\$ 18

	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans (Non-PCI) Past Due 90 Days or More
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December 31,
2016

Commercial
and industrial:

Secured	\$ 4,727	\$ 704	\$ 6,770	\$ 12,201	\$ 1,576,239	\$ 8,672	\$ 1,597,112	\$ 3,095
Unsecured	596	1	909	1,506	97,835	—	99,341	1
Real estate:								
Secured by commercial properties	550	9,417	1,492	11,459	1,915,126	28,510	1,955,095	—
Secured by residential properties	506	361	369	1,236	849,947	10,489	861,672	—
Construction and land development:								
Residential construction loans	—	28	—	28	128,624	—	128,652	—
Commercial construction loans and land development	2,500	1,784	48	4,332	650,399	3,467	658,198	—
Consumer	176	31	—	207	40,851	294	41,352	—
Broker-dealer	—	—	—	—	502,077	—	502,077	—
	\$ 9,055	\$ 12,326	\$ 9,588	\$ 30,969	\$ 5,761,098	\$ 51,432	\$ 5,843,499	\$ 3,096

In addition to the non-covered loans shown in the table above, \$42.7 million and \$44.4 million of loans included in loans held for sale (with an unpaid principal balance of \$43.5 million and \$44.9 million, respectively) were 90 days past due and accruing interest at March 31, 2017 and December 31, 2016, respectively. These loans are guaranteed by U.S. government agencies and include loans that are subject to repurchase, or have been repurchased, by PrimeLending.

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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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.

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

March 31, 2017	Pass	Special Mention	Substandard	PCI	Total
Commercial and industrial:					
Secured	\$ 1,495,445	\$ 853	\$ 57,044	\$ 8,013	\$ 1,561,355
Unsecured	93,186	—	1,404	—	94,590
Real estate:					
Secured by commercial properties	2,001,976	975	28,465	26,568	2,057,984
Secured by residential properties	775,056	3,321	5,691	10,193	794,261
Construction and land development:					
Residential construction loans	136,354	—	—	—	136,354
Commercial construction loans and land development	627,893	—	838	2,713	631,444
Consumer	42,128	5	245	278	42,656
Broker-dealer	465,209	—	—	—	465,209
	\$ 5,637,247	\$ 5,154	\$ 93,687	\$ 47,765	\$ 5,783,853

December 31, 2016	Pass	Special Mention	Substandard	PCI	Total
Commercial and industrial:					
Secured	\$ 1,531,895	\$ 72	\$ 56,473	\$ 8,672	\$ 1,597,112
Unsecured	97,646	—	1,695	—	99,341
Real estate:					
Secured by commercial properties	1,888,231	3,693	34,661	28,510	1,955,095
Secured by residential properties	846,420	—	4,763	10,489	861,672
Construction and land development:					
Residential construction loans	128,624	—	28	—	128,652
Commercial construction loans and land development	653,808	—	923	3,467	658,198
Consumer	40,789	6	263	294	41,352
Broker-dealer	502,077	—	—	—	502,077
	\$ 5,689,490	\$ 3,771	\$ 98,806	\$ 51,432	\$ 5,843,499

Allowance for Loan Losses

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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

and Lease Losses and the Receivables and Contingencies Topics of the ASC is described in detail in Note 5 to the consolidated financial statements included in the Company's 2016 Form 10-K.

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

Three Months Ended March 31, 2017	Commercial and		Construction and		Broker-Dealer	Total
	Industrial	Real Estate	Land Development	Consumer		
Balance, beginning of period	\$ 21,369	\$ 25,236	\$ 7,002	\$ 424	\$ 155	\$ 54,186
Provision charged to (recapture from) operations	475	922	(112)	56	(132)	1,209
Loans charged off	(605)	(82)	(11)	(34)	—	(732)
Recoveries on charged off loans	440	36	—	18	—	494
Balance, end of period	\$ 21,679	\$ 26,112	\$ 6,879	\$ 464	\$ 23	\$ 55,157

Three Months Ended March 31, 2016	Commercial and		Construction and		Broker-Dealer	Total
	Industrial	Real Estate	Land Development	Consumer		
Balance, beginning of period	\$ 19,845	\$ 18,983	\$ 6,064	\$ 314	\$ 209	\$ 45,415
Provision charged to (recapture from) operations	1,016	3,233	(503)	32	(93)	3,685
Loans charged off	(1,350)	—	—	(52)	(2)	(1,404)
Recoveries on charged off loans	658	56	—	40	—	754
Balance, end of period	\$ 20,169	\$ 22,272	\$ 5,561	\$ 334	\$ 114	\$ 48,450

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

March 31, 2017	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Broker-Dealer	Total
Loans individually evaluated for impairment	\$ 8,719	\$ 10,842	\$ 661	\$ 186	\$ —	\$ 20,408
Loans collectively evaluated for impairment	1,639,213	2,804,642	764,424	42,192	465,209	5,715,680
PCI Loans	8,013	36,761	2,713	278	—	47,765
	\$ 1,655,945	\$ 2,852,245	\$ 767,798	\$ 42,656	\$ 465,209	\$ 5,783,853

December 31, 2016	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Broker-Dealer	Total
Loans individually evaluated for impairment	\$ 4,508	\$ 9,704	\$ 727	\$ 205	\$ —	\$ 15,144
Loans collectively evaluated for impairment	1,683,273	2,768,064	782,656	40,853	502,077	5,776,923
PCI Loans	8,672	38,999	3,467	294	—	51,432
	\$ 1,696,453	\$ 2,816,767	\$ 786,850	\$ 41,352	\$ 502,077	\$ 5,843,499

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

March 31, 2017	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Broker-Dealer	Total
Loans individually evaluated for impairment	\$ 778	\$ —	\$ 144	\$ —	\$ —	\$ 922
Loans collectively evaluated for impairment	20,693	24,058	6,409	399	23	51,582
PCI Loans	208	2,054	326	65	—	2,653

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\$ 21,679 \$ 26,112 \$ 6,879 \$ 464 \$ 23 \$ 55,157

December 31, 2016	Commercial and Industrial	Real Estate	Construction and Land Development	Consumer	Broker-Dealer	Total
Loans individually evaluated for impairment	\$ 115	\$ —	\$ 167	\$ —	\$ —	\$ 282
Loans collectively evaluated for impairment	20,697	23,129	6,458	368	155	50,807
PCI Loans	557	2,107	377	56	—	3,097
	\$ 21,369	\$ 25,236	\$ 7,002	\$ 424	\$ 155	\$ 54,186

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

6. Covered Assets and Indemnification Asset

The Bank acquired certain assets and assumed certain liabilities of FNB in connection with an FDIC-assisted transaction on September 13, 2013 (the “Bank Closing Date”). As part of the Purchase and Assumption Agreement by and among the FDIC (as receiver of FNB), the Bank and the FDIC (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 sheets. Collectively, covered loans and covered OREO are referred to as “covered assets”. 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 net losses on the first \$240.4 million of net losses incurred; (ii) 0% of net losses in excess of \$240.4 million up to and including \$365.7 million of net losses incurred; and (iii) 80% of net losses in excess of \$365.7 million of net losses incurred. Net losses are defined as book value losses plus certain defined expenses incurred in the resolution of assets, less subsequent recoveries. Under the loss-share agreement for commercial assets, the amount of subsequent recoveries that are reimbursable to the FDIC for a particular asset is limited to book value losses and expenses actually billed plus any book value charge-offs incurred prior to the Bank Closing Date. There is no limit on the amount of subsequent recoveries reimbursable to the FDIC under the loss-share agreement for single family residential assets. The loss-share agreements for commercial and single family residential assets are in effect for five years and ten years, respectively, from the Bank Closing Date, and the loss recovery provisions to the FDIC are in effect for eight years and ten years, respectively, from the Bank Closing Date. The asset arising from the loss-share agreements, referred 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 its actual net realized losses over the life of the loss-share agreements are less than the FDIC’s initial estimate of losses on covered assets. The “true-up” payment is calculated using a defined formula set forth in the P&A Agreement. At March 31, 2017, the Bank has recorded a related “true-up” payment accrual of \$14.9 million based on the current estimate of aggregate realized losses on covered assets over the life of the loss-share agreements.

Covered Loans and Allowance for Covered Loan Losses

Loans acquired in the FNB Transaction that are subject to a loss-share agreement are referred to as “covered loans” and reported separately in the consolidated balance sheets. Covered loans are reported exclusive of the cash flow

reimbursements that may be received from the FDIC.

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

In connection with the FNB Transaction, the Bank acquired loans both with and without evidence of credit quality deterioration since origination. The Company's accounting policies for acquired covered loans, including covered PCI loans, are consistent with the accounting policies for 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	March 31, 2017	December 31, 2016
Commercial and industrial	\$ 2,022	\$ 2,697
Real estate	227,241	244,469
Construction and land development	6,171	8,961
	235,434	256,127
Allowance for covered loans	(753)	(413)
Total covered loans, net of allowance	\$ 234,681	\$ 255,714

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

	March 31, 2017	December 31, 2016
Carrying amount	\$ 118,393	\$ 133,754
Outstanding balance	240,801	266,098

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

	Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 143,731	\$ 176,719
Reclassifications from nonaccretable difference, net(1)	11,406	9,633
Transfer of loans to covered OREO(2)	(118)	(109)
Accretion	(12,553)	(17,110)
Balance, end of period	\$ 142,466	\$ 169,133

- (1) Reclassifications from nonaccretable difference are primarily due to net increases in expected cash flows in the quarterly recasts, but may also include the reclassification and immediate income recognition of nonaccretable difference due to the favorable resolution of loans accounted for individually. Reclassifications to nonaccretable difference occur when accruing loans are moved to non-accrual and expected cash flows are no longer predictable and the accretable yield is eliminated.
- (2) Transfer of loans to covered OREO is the difference between the value removed from the pool and the expected cash flows for the loan.

The remaining nonaccretable difference for covered PCI loans was \$66.6 million and \$94.5 million at March 31, 2017 and December 31, 2016, respectively. During the three months ended March 31, 2017 and 2016, a combination of factors affecting the inputs to the Bank's quarterly recast process led to the reclassifications from nonaccretable difference to accretable yield. These transfers resulted from revised cash flows that reflect better-than-expected performance of the covered PCI loan portfolio as a result of the Bank's strategic decision to dedicate resources to the liquidation of covered loans during the noted periods.

Covered impaired loans include non-accrual loans, TDRs, PCI loans and partially charged-off loans. The amounts shown in the 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Covered impaired loans, segregated between those considered to be PCI loans and those without credit impairment at acquisition, are summarized by class in the following tables (in thousands).

	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
March 31, 2017					
PCI					
Commercial and industrial:					
Secured	\$ 5,350	\$ 537	\$ 191	\$ 728	\$ 7
Unsecured	6,908	173	—	173	—
Real estate:					
Secured by commercial properties	130,869	29,355	15,326	44,681	578
Secured by residential properties	142,319	69,043	1,192	70,235	125
Construction and land development:					
Residential construction loans	879	—	—	—	—
Commercial construction loans and land development	20,310	2,576	—	2,576	—
	306,635	101,684	16,709	118,393	710
Non-PCI					
Commercial and industrial:					
Secured	52	52	—	52	—
Unsecured	—	—	—	—	—
Real estate:					
Secured by commercial properties	392	302	—	302	—
Secured by residential properties	4,445	3,793	—	3,793	—
Construction and land development:					
Residential construction loans	—	—	—	—	—
Commercial construction loans and land development	36	30	—	30	—
	4,925	4,177	—	4,177	—
	\$ 311,560	\$ 105,861	\$ 16,709	\$ 122,570	\$ 710

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December 31, 2016	Unpaid Contractual Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance
PCI					
Commercial and industrial:					
Secured	\$ 10,579	\$ 1,024	\$ 189	\$ 1,213	\$ 13
Unsecured	3,259	299	—	299	—
Real estate:					
Secured by commercial properties	143,934	26,415	26,222	52,637	271
Secured by residential properties	148,384	73,240	1,161	74,401	60
Construction and land development:					
Residential construction loans	766	—	—	—	—
Commercial construction loans and land development	23,522	5,204	—	5,204	—
	330,444	106,182	27,572	133,754	344
Non-PCI					
Commercial and industrial:					
Secured	52	52	—	52	—
Unsecured	—	—	—	—	—
Real estate:					
Secured by commercial properties	396	310	—	310	—
Secured by residential properties	4,175	3,537	—	3,537	—
Construction and land development:					
Residential construction loans	—	—	—	—	—
Commercial construction loans and land development	24	20	—	20	—
	4,647	3,919	—	3,919	—
	\$ 335,091	\$ 110,101	\$ 27,572	\$ 137,673	\$ 344

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Three Months Ended March 31,	
	2017	2016
Commercial and industrial:		
Secured	\$ 1,023	\$ 5,509
Unsecured	236	1,786
Real estate:		
Secured by commercial properties	48,965	92,941
Secured by residential properties	75,983	95,788
Construction and land development:		
Residential construction loans	—	673
Commercial construction loans and land development	3,915	17,365
	\$ 130,122	\$ 214,062

Covered non-accrual loans are summarized by class in the following table (in thousands).

	March 31, 2017	December 31, 2016
Commercial and industrial:		
Secured	\$ 52	\$ 52
Unsecured	—	—
Real estate:		
Secured by commercial properties	302	730
Secured by residential properties	3,294	3,035
Construction and land development:		
Residential construction loans	—	—
Commercial construction loans and land development	30	19
	\$ 3,678	\$ 3,836

At March 31, 2017, there were no covered PCI loans included within non-accrual loans for which discount accretion has been suspended. At December 31, 2016, covered non-accrual loans included covered PCI loans of \$0.4 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, including recoveries and cash payments, recorded on covered impaired loans was \$0.1 million during the three months ended March 31, 2017, while interest income recorded on covered impaired loans during the three months ended March 31, 2016 was nominal. Except as noted above, covered PCI loans are considered to be performing due to the application of the accretion method.

The Bank classifies loan modifications of covered loans as TDRs in a manner consistent with that of non-covered loans as discussed in Note 5 to the consolidated financial statements. The Bank did not grant any TDRs during the three months ended March 31, 2017 and 2016, respectively. Pooled Loans are not in the scope of the disclosure requirements for TDRs. At March 31, 2017 and December 31, 2016, the Bank had nominal unadvanced commitments to borrowers whose loans have been restructured in TDRs.

There were no TDRs granted during the twelve months preceding March 31, 2017 and 2016, respectively, for which a payment was at least 30 days past due.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Loans Past Due 30 - 59 Days	Loans Past Due 60 - 89 Days	Loans Past Due 90 Days or More	Total Past Due Loans	Current Loans	PCI Loans	Total Loans	Accruing Loans (Non-PCI) Past Due 90 Days or More
March 31, 2017								
Commercial and industrial:								
Secured	\$ —	\$ —	\$ 96	\$ 96	\$ 1,025	\$ 728	\$ 1,849	\$ 44
Unsecured	—	—	—	—	—	173	173	—
Real estate:								
Secured by commercial properties	74	—	—	74	18,446	44,681	63,201	—
Secured by residential properties	3,352	1,182	1,361	5,895	87,910	70,235	164,040	—
Construction and land development:								
Residential construction loans	—	—	—	—	—	—	—	—
Commercial construction loans and land development	—	—	13	13	3,582	2,576	6,171	—
	\$ 3,426	\$ 1,182	\$ 1,470	\$ 6,078	\$ 110,963	\$ 118,393	\$ 235,434	\$ 44

	Loans Past Due 30 - 59 Days		Loans Past Due 60 - 89 Days		Loans Past Due 90 Days or More		Current Loans	PCI Loans	Total Loans	Accruing Loans (Non-PCI) Past Due 90 Days or More
December 31, 2016	30 - 59 Days	60 - 89 Days	90 Days or More	Total	Current Loans	PCI Loans	Total Loans	90 Days or More		
Commercial and industrial:										
Secured	\$ —	\$ 6	\$ 96	\$ 102	\$ 1,083	\$ 1,213	\$ 2,398	\$ 44		
Unsecured	—	—	—	—	—	299	299	—		
Real estate:										

Secured by commercial properties	96	229	—	325	19,132	52,637	72,094	—
Secured by residential properties	3,511	1,345	1,479	6,335	91,639	74,401	172,375	129
Construction and land development:								
Residential construction loans	—	—	—	—	—	—	—	—
Commercial construction loans and land development	15	—	—	15	3,742	5,204	8,961	—
	\$ 3,622	\$ 1,580	\$ 1,575	\$ 6,777	\$ 115,596	\$ 133,754	\$ 256,127	\$ 173

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).

March 31, 2017	Pass	Special Mention	Substandard	PCI	Total
Commercial and industrial:					
Secured	\$ 543	\$ —	\$ 578	\$ 728	\$ 1,849
Unsecured	—	—	—	173	173
Real estate:					
Secured by commercial properties	17,210	—	1,310	44,681	63,201
Secured by residential properties	86,695	453	6,657	70,235	164,040
Construction and land development:					
Residential construction loans	—	—	—	—	—
Commercial construction loans and land development	2,143	—	1,452	2,576	6,171
	\$ 106,591	\$ 453	\$ 9,997	\$ 118,393	\$ 235,434

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

December 31, 2016	Pass	Special Mention	Substandard	PCI	Total
Commercial and industrial:					
Secured	\$ 592	\$ —	\$ 593	\$ 1,213	\$ 2,398
Unsecured	—	—	—	299	299
Real estate:					
Secured by commercial properties	17,996	—	1,461	52,637	72,094
Secured by residential properties	90,563	461	6,950	74,401	172,375
Construction and land development:					
Residential construction loans	—	—	—	—	—
Commercial construction loans and land development	2,281	—	1,476	5,204	8,961
	\$ 111,432	\$ 461	\$ 10,480	\$ 133,754	\$ 256,127

The Bank's impairment methodology for covered loans is consistent with the methodology for non-covered loans, and is discussed in detail in Notes 5 and 6 to the consolidated financial statements included in the Company's 2016 Form 10-K.

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

	Commercial and Industrial	Real Estate	Construction and Land Development	Total
Three months ended March 31, 2017				
Balance, beginning of period	\$ 35	\$ 378	\$ —	\$ 413
Provision charged to (recapture from) operations	(17)	513	—	496
Loans charged off	(6)	(160)	—	(166)
Recoveries on charged off loans	4	5	1	10
Balance, end of period	\$ 16	\$ 736	\$ 1	\$ 753
Three months ended March 31, 2016				
Balance, beginning of period	\$ 758	\$ 774	\$ —	\$ 1,532
Provision charged to (recapture from) operations	(314)	(23)	59	(278)

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Loans charged off	(6)	(16)	(22)	(44)
Recoveries on charged off loans	—	7	—	7
Balance, end of period	\$ 438	\$ 742	\$ 37	\$ 1,217

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

March 31, 2017	Commercial and Industrial	Real Estate	Construction and Land Development	Total
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	1,121	112,325	3,595	117,041
PCI Loans	901	114,916	2,576	118,393
	\$ 2,022	\$ 227,241	\$ 6,171	\$ 235,434

December 31, 2016	Commercial and Industrial	Real Estate	Construction and Land Development	Total
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	1,185	117,431	3,757	122,373
PCI Loans	1,512	127,038	5,204	133,754
	\$ 2,697	\$ 244,469	\$ 8,961	\$ 256,127

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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	Total
March 31, 2017				
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	9	33	1	43
PCI Loans	7	703	—	710
	\$ 16	\$ 736	\$ 1	\$ 753

	Commercial and Industrial	Real Estate	Construction and Land Development	Total
December 31, 2016				
Loans individually evaluated for impairment	\$ —	\$ —	\$ —	\$ —
Loans collectively evaluated for impairment	22	47	—	69
PCI Loans	13	331	—	344
	\$ 35	\$ 378	\$ —	\$ 413

Covered Other Real Estate Owned

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

	Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 51,642	\$ 99,090
Additions to covered OREO	1,723	4,542
Dispositions of covered OREO	(6,799)	(14,977)
Valuation adjustments in the period	(1,192)	(9,765)
Balance, end of period	\$ 45,374	\$ 78,890

During the three months ended March 31, 2017 and 2016, the Bank wrote down certain covered OREO assets to fair value to reflect new appraisals on certain OREO acquired in the FNB Transaction and OREO acquired from the foreclosure on certain FNB loans acquired in the FNB Transaction. Although the Bank recorded a fair value discount on the acquired assets upon acquisition, in some cases additional downward valuations were required.

These additional downward valuation adjustments reflect changes to the assumptions regarding the fair value of the OREO, including in some cases the intended use of the OREO due to the availability of more information, as well as the passage of time. The process of determining fair value is subjective in nature and requires the use of significant estimates and assumptions. Although the Bank makes market-based assumptions when valuing acquired assets, new information may come to light that causes estimates to increase or decrease. When the Bank determines, based on subsequent information, that its estimates require adjustment, the Bank records the adjustment. The accounting for such adjustments requires that the decreases to the initially recorded fair value be recorded at the time such new information is received, while increases to fair value are recorded when the asset is subsequently sold.

FDIC Indemnification Asset

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

	Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 71,313	\$ 91,648
FDIC Indemnification Asset accretion (amortization)	(3,949)	87
Transfers to due from FDIC and other	(19,424)	(11,213)
Balance, end of period	\$ 47,940	\$ 80,522

As of March 31, 2017, the Bank had billed and collected \$140.3 million from the FDIC, which represented reimbursable covered losses and expenses through December 31, 2016.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

7. Mortgage Servicing Rights

The following tables present the changes in fair value of the Company's MSR asset, as included in other assets within the consolidated balance sheets, and other information related to the serviced portfolio (dollars in thousands).

	Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 61,968	\$ 52,285
Additions	1,224	1,639
Sales	(17,499)	—
Changes in fair value:		
Due to changes in model inputs or assumptions (1)	857	(12,842)
Due to customer payoffs	(977)	(1,219)
Balance, end of period	\$ 45,573	\$ 39,863

	March 31,		December 31,	
	2017		2016	
Mortgage loans serviced for others	\$ 3,789,523		\$ 5,480,943	
MSR asset as a percentage of serviced mortgage loans	1.20	%	1.13	%

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

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

	March 31,		December 31,	
	2017		2016	
Weighted average constant prepayment rate	10.45	%	10.47	%
Weighted average discount rate	11.14	%	10.95	%
Weighted average life (in years)	7.0		6.9	

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

	March 31, 2017	December 31, 2016
Constant prepayment rate:		
Impact of 10% adverse change	\$ (1,648)	\$ (2,297)
Impact of 20% adverse change	(3,235)	(4,471)
Discount rate:		
Impact of 10% adverse change	(1,895)	(2,539)
Impact of 20% adverse change	(3,641)	(4,882)

This sensitivity analysis presents the effect of hypothetical changes in key assumptions on the fair value of the MSR asset. 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 asset 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 \$6.5 million and \$5.9 million during the three months ended March 31, 2017 and 2016, respectively, were included in other noninterest income within the consolidated statements of operations.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

8. Deposits

Deposits are summarized as follows (in thousands).

	March 31, 2017	December 31, 2016
Noninterest-bearing demand	\$ 2,272,905	\$ 2,199,483
Interest-bearing:		
NOW accounts	1,224,157	1,252,832
Money market	1,891,500	1,626,218
Brokered - money market	125,205	125,272
Demand	389,376	384,847
Savings	239,743	279,911
Time	1,166,383	1,145,859
Brokered - time	20,593	49,389
	\$ 7,329,862	\$ 7,063,811

9. Short-term Borrowings

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

	March 31, 2017	December 31, 2016
Federal funds purchased	\$ 112,350	\$ 87,125
Securities sold under agreements to repurchase	364,927	195,164
Federal Home Loan Bank	150,000	1,000,000
Short-term bank loans	126,500	135,000
	\$ 753,777	\$ 1,417,289

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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 the Hilltop Broker-Dealers execute transactions to sell securities under agreements to repurchase with both customers and other broker-dealers. Securities involved in these transactions are held by the Bank, the Hilltop Broker-Dealers or a third-party dealer.

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

	Three Months Ended March			
	31,		2016	
	2017		2016	
Average balance during the period	\$ 386,624		\$ 329,392	
Average interest rate during the period	0.76	%	0.49	%

	March 31,		December	
	2017		31,	
	2017		2016	
Average interest rate at end of period	0.69	%	0.42	%
Securities underlying the agreements at end of period:				
Carrying value	\$ 371,859		\$ 209,877	
Estimated fair value	\$ 379,390		\$ 206,641	

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Federal Home Loan Bank (“FHLB”) short-term borrowings 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 short-term borrowings is shown in the following tables (dollars in thousands).

	Three Months Ended March 31,			
	2017		2016	
Average balance during the period	\$ 180,000		\$ 234,341	
Average interest rate during the period	0.61	%	0.44	%

	March 31, 2017		December 31, 2016	
Average interest rate at end of period	0.90	%	0.55	%

The Hilltop Broker-Dealers use 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 March 31, 2017 and December 31, 2016 was 1.84% and 1.59%, respectively.

10. Notes Payable

Notes payable consisted of the following (in thousands).

	March 31, 2017	December 31, 2016
Senior Notes due April 2025, net of discount of \$1,654 and \$1,689, respectively	\$ 148,346	\$ 148,311
	102,194	102,596

FHLB notes, net of premium of \$572 and \$627, respectively, with maturities ranging from April 2017 to June 2030

Insurance company note payable due March 2035	20,000	20,000
NLIC note payable due May 2033	10,000	10,000
NLIC note payable due September 2033	10,000	10,000
ASIC note payable due April 2034	7,500	7,500
Insurance company line of credit due December 31, 2017	3,000	3,000
Ventures line of credit due August 2017	17,952	16,505
Mutual line of credit due October 2017	5,709	—
	\$ 324,701	\$ 317,912

11. Income Taxes

The Company applies an estimated annual effective rate to interim period pre-tax income to calculate the income tax provision for the quarter in accordance with the principal method prescribed by the accounting guidance established for computing income taxes in interim periods. The Company's effective tax rate was 36.4% and 33.8% during the three months ended March 31, 2017 and 2016, respectively. The effective tax rate during the three months ended March 31, 2016 was lower than the statutory rate primarily due to the recognition of excess tax benefits on share-based payment awards.

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

12. 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. A portion 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, the Company does not take into account the availability of insurance coverage, other than that provided by reinsurers in the insurance segment. 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. As available information changes, however, 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 is complete; whether meaningful settlement discussions have 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.

Following completion of Hilltop's acquisition of SWS, several purported holders of shares of SWS common stock filed petitions in the Court of Chancery of the State of Delaware seeking appraisal for their shares pursuant to Section 262 of the Delaware General Corporation Law. These petitions were consolidated as *In re SWS Group, Inc.*, C.A. No. 10554-VCG. The consolidated matter represents a total of approximately 5.2 million shares of SWS common stock. The Company continues to vigorously defend this matter.

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 certain of its businesses, business practices and policies, as well as the conduct of persons with whom it does business. Additional Inquiries will arise from time to time. In connection with those Inquiries, the Company receives document requests, subpoenas and other requests for information. The Inquiries, including the Inquiry described below, could develop into administrative, civil or criminal proceedings or enforcement actions that could result in consequences that have a material effect on the Company's consolidated financial position, results of operations or cash flows as a whole. Such consequences could include adverse judgments, findings, settlements, penalties, fines, orders, injunctions, restitution, or alterations in the Company's business practices, and could result in additional expenses and collateral costs, including reputational damage.

As a part of an industry-wide Inquiry, PrimeLending received a subpoena from the Office of Inspector General of the U.S. Department of Housing and Urban Development regarding mortgage-related practices, including those relating to origination practices for loans insured by the Federal Housing Administration (the “FHA”). On August 20, 2014, PrimeLending received a Civil Investigative Demand from the United States Department of Justice (the “DOJ”) related to this Inquiry. According to the Civil Investigative Demand, the DOJ is conducting an investigation to determine whether PrimeLending has violated the False Claims Act in connection with originating and underwriting single-family residential mortgage loans insured by the FHA. The DOJ has advised PrimeLending that, based upon its review of a sample of loans for which an FHA insurance claim was paid by the U.S. Department of Housing and Urban Development (“HUD”), some of the loans do not meet FHA underwriting guidelines. PrimeLending, based upon its own

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(Unaudited)

review of the loan sample, does not agree with the sampling methodology and loan analysis employed by the DOJ. Remedies in these proceedings or settlements may include statutory damages, indemnification, fines and/or penalties. While we cannot estimate PrimeLending's liability at this time, many institutions have settled these matters on terms that included large monetary penalties. PrimeLending has fully cooperated with this Inquiry, and continues its discussions with the DOJ.

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, except related to specific matters disclosed above, 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.

At March 31, 2017 and December 31, 2016, the mortgage origination segment's indemnification liability reserve totaled \$19.0 million and \$18.2 million, respectively. The provision for indemnification losses was \$0.8 million and \$0.9 million during the three months ended March 31, 2017 and 2016, respectively.

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

	Representation and Warranty Specific Claims Activity - Origination Loan Balance Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 40,669	\$ 57,298
Claims made	8,379	4,548
Claims resolved with no payment	(8,098)	(6,115)
Repurchases	(1,461)	(1,157)
Indemnification payments	(244)	(372)
Balance, end of period	\$ 39,245	\$ 54,202

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

	Indemnification Liability Reserve Activity	
	Three Months Ended March 31,	
	2017	2016
Balance, beginning of period	\$ 18,239	\$ 16,640
Additions for new sales	847	878
Repurchases	(102)	(112)
Early payment defaults	(69)	(90)
Indemnification payments	(42)	(169)
Change in estimate	79	—
Balance, end of period	\$ 18,952	\$ 17,147
	March 31,	December 31,
	2017	2016
Reserve for Indemnification Liability:		
Specific claims	\$ 1,751	\$ 1,661
Incurred but not reported claims	17,201	16,578
Total	\$ 18,952	\$ 18,239

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 net losses on the first \$240.4 million of net losses incurred; (ii) 0% of net losses in excess of \$240.4 million up to and including \$365.7 million of net losses incurred; and (iii) 80% of net losses in excess of \$365.7 million of net losses incurred. Net losses are defined as book value losses plus certain defined expenses incurred in the resolution of assets, less subsequent recoveries. Under the loss-share agreement for commercial assets, the amount of subsequent recoveries that are reimbursable to the FDIC for a particular asset is limited to book value losses and expenses actually billed plus any book value charge-offs incurred prior to the Bank Closing Date. There is no limit on the amount of subsequent recoveries reimbursable to the FDIC under the loss-share agreement for single family residential assets. The loss-share agreements for commercial and single family residential assets are in effect for five years and ten years, respectively, from the Bank Closing Date and the loss recovery provisions to the FDIC are in effect for eight years and ten years, respectively, from the Bank Closing Date. As discussed in Note 6 to the consolidated financial statements, and 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 its actual net realized losses over the life of the loss-share agreements are less than the FDIC’s initial estimate of losses on covered assets. The “true-up” payment is

calculated using a defined formula set forth in the P&A Agreement. While the ultimate amount of any “true-up” payment is unknown at this time and will vary based upon the amount of future losses or recoveries within our covered loan portfolio, the Bank has recorded a related “true-up” payment accrual of \$14.9 million at March 31, 2017 based on the current estimate of aggregate realized losses on covered assets over the life of the loss-share agreements. The initial estimate of the FDIC Indemnification Asset at the Bank Closing Date was recorded at the present value of 80% of \$240.4 million. As of March 31, 2017, the Bank projects that the sum of actual plus projected covered losses and reimbursable expenses subject to the loss-share agreements will be less than \$240.4 million. As of March 31, 2017, the Bank had billed \$175.4 million of covered net losses to the FDIC, of which 80%, or \$140.3 million, were reimbursable under the loss-share agreements. As of March 31, 2017, the Bank had received aggregate reimbursements of \$140.3 million from the FDIC, which represented reimbursable covered losses and expenses through December 31, 2016.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

13. Financial Instruments with Off-Balance Sheet Risk

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

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

In the aggregate, the Bank had outstanding unused commitments to extend credit of \$1.9 billion at March 31, 2017 and outstanding financial and performance standby letters of credit of \$32.7 million at March 31, 2017.

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, the Hilltop Broker-Dealers execute, settle, and finance various securities transactions that may expose the Hilltop Broker-Dealers 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 accounts of the Hilltop Broker-Dealers, use of derivatives to support certain non-profit housing organization clients, clearing agreements between the Hilltop Broker-Dealers and various clearinghouses and broker-dealers, secured financing arrangements that involve pledged securities, and when-issued underwriting and purchase commitments.

14. Stock-Based Compensation

Pursuant to the Hilltop Holdings Inc. 2012 Equity Incentive Plan (the “2012 Plan”), the Company may grant nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units (“RSUs”), performance awards, dividend equivalent rights and other awards to employees of the Company, its subsidiaries and outside directors of the Company. In the aggregate, 4,000,000 shares of common stock may be delivered pursuant to awards granted under the 2012 Plan. At March 31, 2017, 1,769,625 shares of common stock remained available for issuance pursuant to the 2012 Plan, including shares that may be delivered pursuant to outstanding awards. Compensation expense related to the 2012 Plan was \$2.7 million and \$2.3 million during the three months ended March 31, 2017 and 2016, respectively.

During the three months ended March 31, 2017 and 2016, Hilltop granted 3,513 and 5,516 shares of common stock, respectively, pursuant to the 2012 Plan to certain non-employee members of the Company’s Board of Directors for services rendered to the Company.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Restricted Stock Awards and RSUs

The following table summarizes information about nonvested Restricted Stock Award and RSU activity for the three months ended March 31, 2017 (shares in thousands).

	Restricted Stock Awards		RSUs	
		Weighted Average Grant Date Fair Value		Weighted Average Grant Date Fair Value
	Outstanding		Outstanding	
Balance, December 31, 2016	4	\$ 19.95	1,456	\$ 19.83
Granted	-	\$ -	228	\$ 28.15
Vested/Released	-	\$ -	(151)	\$ 23.38
Forfeited	-	\$ -	(37)	\$ 24.36
Balance, March 31, 2017	4	\$ 19.95	1,496	\$ 20.63

Vested/Released Restricted Stock Awards and RSUs include an aggregate of 29,727 shares withheld to satisfy employee statutory tax obligations during the three months ended March 31, 2017. Pursuant to certain RSU award agreements, an aggregate of 8,247 vested RSUs at March 31, 2017 require deferral of the settlement in shares and statutory tax obligations to a future date.

At March 31, 2017, unrecognized compensation expense related to outstanding Restricted Stock Awards of \$27 thousand is expected to be recognized over a weighted average period of 0.39 years.

During the three months ended March 31, 2017, the Compensation Committee of the Board of Directors of the Company awarded certain executives and key employees an aggregate of 210,888 RSUs pursuant to the 2012 Plan. At March 31, 2017, 121,449 of these outstanding RSUs are subject to time-based vesting conditions and generally cliff vest on the third anniversary of the grant date, and 89,439 of these outstanding RSUs will cliff vest based upon the achievement of certain performance goals over a three-year period.

At March 31, 2017, in the aggregate, 1,191,893 of the outstanding RSUs are subject to time-based vesting conditions and generally cliff vest on the third anniversary of the grant date, and 303,800 outstanding RSUs cliff vest based upon the achievement of certain performance goals over a three-year period. At March 31, 2017, unrecognized compensation expense related to outstanding RSUs of \$16.3 million is expected to be recognized over a weighted average period of 1.54 years.

15. Regulatory Matters

Banking and Hilltop

PlainsCapital 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 PlainsCapital and Hilltop 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 Company performs reviews of the classification and calculation of risk-weighted assets to ensure accuracy and compliance with the Basel III regulatory capital requirements. 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 common equity Tier 1, Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

In order to avoid limitations on capital distributions, including dividend payments, stock repurchases and certain discretionary bonus payments to executive officers, Basel III also implemented a capital conservation buffer, which

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

requires a banking organization to hold a buffer above its minimum risk-based capital requirements. This buffer will help to ensure that banking organizations conserve capital when it is most needed, allowing them to better weather periods of economic stress. The buffer is measured relative to risk-weighted assets. The phase-in of the capital conservation buffer requirements began on January 1, 2016 for Hilltop and the Bank. Based on the actual ratios as shown in the table below, Hilltop and the Bank exceed each of the capital conservation buffer requirements in effect as of March 31, 2017, as well as the fully phased-in requirements through 2019.

The following table shows the PlainsCapital's and Hilltop's actual capital amounts and ratios in accordance with Basel III compared to the regulatory minimum capital requirements including conservation buffer in effect at the end of the period and on a fully phased-in basis as if such requirements were currently in effect as measured at March 31, 2017 and December 31, 2016, respectively (dollars in thousands). Based on actual capital amounts and ratios shown in the following table, PlainsCapital's ratios place it in the "well capitalized" (as defined) capital category under regulatory requirements.

				Minimum Capital Requirements Including Conservation Buffer					
	Actual Amount	Ratio		In Effect at End of Period Ratio		Fully Phased In Ratio		To Be Well Capitalized Ratio	
March 31, 2017									
Tier 1 capital (to average assets):									
PlainsCapital	\$ 1,125,727	13.09	%	4.0	%	4.0	%	5.0	%
Hilltop	1,654,189	13.98	%	4.0	%	4.0	%	N/A	
Common equity Tier 1 capital (to risk-weighted assets):									
PlainsCapital	1,125,727	15.50	%	5.75	%	7.0	%	6.5	%
Hilltop	1,604,840	19.03	%	5.75	%	7.0	%	N/A	
Tier 1 capital (to risk-weighted assets):									
PlainsCapital	1,125,727	15.50	%	7.25	%	8.5	%	8.0	%
Hilltop	1,654,189	19.62	%	7.25	%	8.5	%	N/A	
Total capital (to risk-weighted assets):									
PlainsCapital	1,183,495	16.30	%	9.25	%	10.5	%	10.0	%
Hilltop	1,696,330	20.12	%	9.25	%	10.5	%	N/A	

December 31, 2016

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Tier 1 capital (to average assets):								
PlainsCapital	\$ 1,108,484	12.35	%	4.0	%	4.0	%	5.0
Hilltop	1,652,101	13.51	%	4.0	%	4.0	%	N/A
Common equity Tier 1 capital (to risk-weighted assets):								
PlainsCapital	1,108,484	14.64	%	5.125	%	7.0	%	6.5
Hilltop	1,602,400	18.30	%	5.125	%	7.0	%	N/A
Tier 1 capital (to risk-weighted assets):								
PlainsCapital	1,108,484	14.64	%	6.625	%	8.5	%	8.0
Hilltop	1,652,101	18.87	%	6.625	%	8.5	%	N/A
Total capital (to risk-weighted assets):								
PlainsCapital	1,164,767	15.38	%	8.625	%	10.5	%	10.0
Hilltop	1,693,240	19.34	%	8.625	%	10.5	%	N/A

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

Broker-Dealer

Pursuant to the net capital requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), Hilltop Securities has elected to determine its net capital requirements using the alternative method. Accordingly, Hilltop Securities 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 and \$1,000,000, respectively, or 2% of aggregate debit balances, as defined in Rule 15c3-3 promulgated under the Exchange Act. Additionally, the net capital rule of the NYSE provides that equity capital may not be withdrawn or cash dividends paid if resulting net capital would be less than 5% of the aggregate debit items. HTS Independent Network follows the primary (aggregate indebtedness) method, as defined in Rule 15c3-1 promulgated under the Exchange Act, which requires the maintenance of the larger of minimum net capital of \$250,000 or 1/15 of aggregate indebtedness.

At March 31, 2017, the net capital position of each of the Hilltop Broker-Dealers was as follows (in thousands).

	Hilltop Securities	HTS Independent Network
Net capital	\$ 158,331	\$ 3,080
Less required net capital	9,267	250
Excess net capital	\$ 149,064	\$ 2,830
Net capital as a percentage of aggregate debit items	34.2	%
Net capital in excess of 5% aggregate debit items	\$ 135,164	

Under certain conditions, Hilltop Securities 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. At March 31, 2017 and December 31, 2016, Hilltop Securities held cash of \$166.4 million and \$181.0 million, respectively, segregated in special reserve bank accounts for the benefit of customers. Hilltop Securities was not required to segregate cash and securities in special reserve accounts for the benefit of proprietary accounts of introducing broker-dealers at March 31, 2017 and December 31, 2016. The fair values of any segregated assets included in special reserve accounts were determined using Level 1 inputs.

Mortgage Origination

As a mortgage originator, PrimeLending and its subsidiaries are subject to minimum net worth and liquidity requirements established by the HUD and the GNMA, as applicable. On an annual basis, PrimeLending and its subsidiaries submit audited financial statements to HUD and GNMA, as applicable, documenting their respective compliance with its minimum net worth and liquidity requirements. As of March 31, 2017, PrimeLending and its subsidiaries' net worth and liquidity exceeded the amounts required by both HUD and GNMA, as applicable.

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 statutory accounting practices of the National Association of Insurance Commissioners ("NAIC") as the basis of its statutory accounting practices with certain differences that are not significant to the insurance company subsidiaries' statutory equity.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	March 31, 2017	December 31, 2016
Capital and surplus:		
National Lloyds Insurance Company	\$ 131,987	\$ 131,328
American Summit Insurance Company	31,369	30,462
	Three Months Ended March 31, 2017	2016
Statutory net income:		
National Lloyds Insurance Company	\$ 636	\$ 3,557
American Summit Insurance Company	832	852

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 March 31, 2017, 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 March 31, 2017, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required.

16. Stockholders' Equity

Dividend Declaration

On April 25, 2017, the Company announced that its board of directors declared a quarterly cash dividend of \$0.06 per common share, payable on May 31, 2017, to all common stockholders of record as of the close of business on May 15, 2017.

Stock Repurchase Program

The Company's Board of Directors reauthorized the stock repurchase program originally approved during the second quarter of 2016 through January 2018, under which the Company may repurchase, in the aggregate, up to \$50.0 million of its outstanding common stock. Under the stock repurchase program, the Company may repurchase shares in open-market purchases or through privately negotiated transactions as permitted under Rule 10b-18 promulgated under the Exchange Act. The extent to which the Company repurchases its shares and the timing of such repurchases depends upon market conditions and other corporate considerations, as determined by Hilltop's management team. During the three months ended March 31, 2017, the Company paid \$7.2 million to repurchase and retire an aggregate of 261,608 shares of common stock at an average price of \$27.52 per share. These retired shares were returned to the Company's pool of authorized but unissued shares of common stock. The purchases were funded from available cash balances. The Company's accounting treatment and policy regarding stock repurchases is discussed in detail in Note 1 to the consolidated financial statements included in the Company's 2016 Form 10-K.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

17. 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 managing the re-pricing characteristics of certain assets and liabilities to mitigate potential adverse impacts from changes in interest rates on 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 interest rate risk from the time an IRLC is made to an applicant to the time the related mortgage loan is sold. To mitigate interest rate risk, PrimeLending executes forward commitments to sell mortgage-backed securities ("MBSs"). Additionally, PrimeLending has interest rate risk relative to its MSR asset and uses derivative instruments, including interest rate swaps, swaptions, and U.S. Treasury bond futures and options to hedge this risk. The Hilltop Broker-Dealers use forward commitments to both purchase and sell MBSs to facilitate customer transactions and as a means to hedge related exposure to interest rate risk in certain inventory positions.

Non-Hedging Derivative Instruments and the Fair Value Option

As discussed in Note 3 to the consolidated financial statements, the Company has elected to measure substantially all mortgage loans held for sale at fair value under the provisions of the Fair Value Option. The election provides the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without applying complex hedge accounting provisions. The fair values of PrimeLending's IRLCs, forward commitments, interest rate swaps and swaptions, and U.S. Treasury bond futures and options are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of these derivative instruments are recorded as a component of net gains from sale of loans and other mortgage production income. The fair value of PrimeLending's derivative instruments increased \$0.7 million and \$12.5 million during the three months ended March 31, 2017 and 2016, respectively. Changes in fair value are attributable to changes in the volume of IRLCs, mortgage loans held for sale, commitments to purchase and sell MBSs and MSR assets, and changes in market interest rates. Changes in market interest rates also conversely affect the value of PrimeLending's mortgage loans held for sale and its MSR asset, which are measured at fair value under the Fair Value Option. The effect of the change in market interest rates on PrimeLending's loans held for sale and MSR asset is discussed in Note 3 to the consolidated financial statements. The fair values of the Hilltop Broker-Dealers' and the Bank's derivative instruments are recorded in other assets or other liabilities, as appropriate. The fair values of the Hilltop Broker-Dealers' derivatives increased \$6.3 million and \$6.9 million during the three months ended March 31, 2017 and 2016, respectively, while the fair values of the Bank's derivatives increased \$0.1 million during the three months ended March 31, 2017, compared with a decrease of \$0.5 million during the three months ended March 31, 2016. The changes in fair value were recorded as a component of other noninterest income.

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

	March 31, 2017		December 31, 2016	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivative instruments:				
IRLCs	\$ 1,427,763	\$ 40,911	\$ 944,550	\$ 23,269
Customer-based written options	2,223	97	—	—
Customer-based purchased options	2,223	(97)	—	—
Commitments to purchase MBSs	3,567,436	14,090	3,616,922	(1,155)
Commitments to sell MBSs	5,881,086	(18,960)	5,609,250	(532)
Interest rate swaps and swaptions	32,239	(159)	32,452	(283)
U.S. Treasury bond futures and options (1)	206,000	—	297,000	—

(1) Changes in the fair value of these contracts are settled daily with PrimeLending's counterparty.

PrimeLending had cash collateral advances totaling \$6.1 million to offset net liability derivative positions on its commitments to sell MBSs at March 31, 2017, compared to a payable of \$19.1 million on its net liability derivative position on its commitments to sell MBSs at December 31, 2016. In addition, PrimeLending advanced cash collateral totaling \$3.2 million on its U.S. Treasury bond futures and options at both March 31, 2017 and December 31, 2016. These amounts are included in other assets within the consolidated balance sheets.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

18. Balance Sheet Offsetting

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

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet Financial Instruments	Cash Collateral Net Pledged	Amount
March 31, 2017						
Securities borrowed:						
Institutional counterparties	\$ 1,507,651	\$ —	\$ 1,507,651	\$ (1,454,971)	\$ —	\$ 52,680
Interest rate options:						
Customer counterparties	97	—	97	—	—	97
Reverse repurchase agreements:						
Institutional counterparties	113,228	—	113,228	(113,083)	—	145
Forward MBS derivatives:						
Institutional counterparties	14,090	—	14,090	(14,090)	—	—
	\$ 1,635,066	\$ —	\$ 1,635,066	\$ (1,582,144)	\$ —	\$ 52,922
December 31, 2016						
Securities borrowed:						

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Institutional counterparties	\$ 1,436,069	\$ —	\$ 1,436,069	\$ (1,385,664)	\$ —	\$ 50,405
Reverse repurchase agreements:						
Institutional counterparties	89,430	—	89,430	(89,369)	—	61
Forward MBS derivatives:						
Institutional counterparties	21,366	(3,893)	17,473	(9,012)	—	8,461
	\$ 1,546,865	\$ (3,893)	\$ 1,542,972	\$ (1,484,045)	\$ —	\$ 58,927

	Gross Amounts of Recognized Liabilities	Gross Amountsof Liabilities Offset in the Balance Sheet	Net Amounts Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet	Cash Collateral Pledged	Net Amount
March 31, 2017						
Securities loaned:						
Institutional counterparties	\$ 1,376,568	\$ —	\$ 1,376,568	\$ (1,326,373)	\$ —	\$ 50,195
Interest rate options:						
Institutional counterparties	97	—	97	—	—	97
Interest rate swaps and swaptions:						
Institutional counterparties	185	(26)	159	(3,000)	—	(2,841)
Repurchase agreements:						
Institutional counterparties	213,344	—	213,344	(213,344)	—	—
Customer counterparties	151,583	—	151,583	(151,583)	—	—
Forward MBS derivatives:						
Institutional counterparties	19,218	(258)	18,960	(10,502)	—	8,458
	\$ 1,760,995	\$ (284)	\$ 1,760,711	\$ (1,704,802)	\$ —	\$ 55,909
December 31, 2016						
Securities loaned:						

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Institutional counterparties	\$ 1,283,676	—	1,283,676	(1,237,868)	—	45,808
Interest rate swaps and swaptions:						
Institutional counterparties	297	(14)	283	(3,000)	—	(2,717)
Repurchase agreements:						
Institutional counterparties	39,970	—	39,970	(39,970)	—	—
Customer counterparties	155,194	—	155,194	(155,194)	—	—
Forward MBS derivatives:						
Institutional counterparties	19,159	—	19,159	(19,159)	—	—
	\$ 1,498,296	\$ (14)	\$ 1,498,282	\$ (1,455,191)	\$ —	\$ 43,091

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

Secured Borrowing Arrangements

Secured Borrowings (Repurchase Agreements) — The Company participates in transactions involving securities sold under repurchase agreements, which are secured borrowings and generally mature within one to thirty days from the transaction date. Securities sold under repurchase agreements are reflected at the amount of cash received in connection with the transactions. The Company may be required to provide additional collateral based on the fair value of the underlying securities, which is monitored on a daily basis.

Securities Lending Activities — The Company's securities lending activities include lending securities for other broker-dealers, lending institutions and its own clearing and retail operations. These activities involve lending securities to other broker-dealers to cover short sales, to complete transactions in which there has been a failure to deliver securities by the required settlement date and as a conduit for financing activities.

When lending securities, the Company receives cash or similar collateral and generally pays interest (based on the amount of cash deposited) to the other party to the transaction. Securities lending transactions are executed pursuant to written agreements with counterparties that generally require securities loaned to be marked-to-market on a daily basis. The Company receives collateral in the form of cash in an amount generally in excess of the fair value of securities loaned. The Company monitors the fair value of securities loaned on a daily basis, with additional collateral obtained or refunded, as necessary. Collateral adjustments are made on a daily basis through the facilities of various clearinghouses. The Company is a principal in these securities lending transactions and is liable for losses in the event of a failure of any other party to honor its contractual obligation. Management sets credit limits with each counterparty and reviews these limits regularly to monitor the risk level with each counterparty. The Company is subject to credit risk through its securities lending activities if securities prices decline rapidly because the value of the Company's collateral could fall below the amount of the indebtedness it secures. In rapidly appreciating markets, credit risk increases due to short positions. The Company's securities lending business subjects the Company to credit risk if a counterparty fails to perform or if collateral securing its obligations is insufficient. In securities transactions, the Company is subject to credit risk during the period between the execution of a trade and the settlement by the customer.

The following tables present the remaining contractual maturities of repurchase agreement and securities lending transactions accounted for as secured borrowings (in thousands). The Company had no repurchase-to-maturity transactions outstanding at both March 31, 2017 and December 31, 2016.

	Remaining Contractual Maturities				
	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
March 31, 2017					
Repurchase agreement transactions:					
U.S. Treasury and agency securities	\$ 204,178	\$ —	\$ —	\$ —	\$ 204,178
Asset-backed securities	—	160,749	—	—	160,749
Securities lending transactions:					
Corporate securities	9,149	—	—	—	9,149
Equity securities	1,367,419	—	—	—	1,367,419
Total	\$ 1,580,746	\$ 160,749	\$ —	\$ —	\$ 1,741,495
Gross amount of recognized liabilities for repurchase agreement and securities lending transactions in offsetting disclosure above					\$ 1,741,495
Amount related to agreements not included in offsetting disclosure above					\$ —

	Remaining Contractual Maturities				
	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
December 31, 2016					
Repurchase agreement transactions:					
U.S. Treasury and agency securities	\$ 195,164	\$ —	\$ —	\$ —	\$ 195,164
Securities lending transactions:					
Corporate securities	14,816	—	—	—	14,816
Equity securities	1,268,860	—	—	—	1,268,860
Total	\$ 1,478,840	\$ —	\$ —	\$ —	\$ 1,478,840
Gross amount of recognized liabilities for repurchase agreement and securities lending transactions in offsetting disclosure above					\$ 1,478,840
Amount related to agreements not included in offsetting disclosure above					\$ —

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

19. Broker-Dealer and Clearing Organization Receivables and Payables

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

	March 31, 2017	December 31, 2016
Receivables:		
Securities borrowed	\$ 1,507,651	\$ 1,436,069
Securities failed to deliver	29,985	33,834
Trades in process of settlement	22,357	10,223
Other	14,038	17,615
	\$ 1,574,031	\$ 1,497,741
Payables:		
Securities loaned	\$ 1,376,568	\$ 1,283,676
Correspondents	35,165	31,040
Securities failed to receive	25,805	31,724
Other	10	688
	\$ 1,437,548	\$ 1,347,128

20. Reserve for Losses and Loss Adjustment Expenses

A summary of NLC's reserve for unpaid losses and LAE, as included in other liabilities within the consolidated balance sheets, is as follows (in thousands).

	March 31, 2017	December 31, 2016
Reserve for unpaid losses and allocated LAE balance, net	\$ 28,544	\$ 25,203
Reinsurance recoverables on unpaid losses	5,118	9,434
Unallocated LAE	1,158	1,189

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Reserve for unpaid losses and LAE balance, gross	\$ 34,820	\$ 35,826
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A summary of claims loss reserve development activity is presented in the following table (in thousands).

Accident Year	Three Months Ended March 31, 2017		March 31, 2017 Total of IBNR Reserves Plus Expected Development on Reported Claims		Cumulative Number of Reported Claims
	Paid	Incurred			
2012	\$ 112,346	\$ 114,598	\$ 35		16,675
2013	109,976	111,085	57		15,753
2014	82,172	84,206	287		13,175
2015	83,679	88,447	2,525		14,915
2016	77,056	86,940	6,018		21,504
2017	9,443	17,845	2,437		3,999
Total	474,672	\$ 503,121			
	95	All outstanding reserves prior to 2012, net of reinsurance			
	\$ 28,544	Reserve for unpaid losses and allocated LAE, net of reinsurance			

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

21. 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 March 31, 2017, reinsurance receivables had a carrying value of \$10.8 million, which is included in other assets within the consolidated balance sheet. There was no allowance for uncollectible accounts at March 31, 2017, based on NLC's quality requirements.

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

	Three Months Ended March 31,			
	2017		2016	
	Written	Earned	Written	Earned
Premiums from direct business	\$ 35,795	\$ 37,198	\$ 39,079	\$ 40,886
Reinsurance assumed	2,869	2,818	2,679	2,669
Reinsurance ceded	(3,213)	(3,876)	(3,498)	(3,822)
Net premiums	\$ 35,451	\$ 36,140	\$ 38,260	\$ 39,733

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

	Three Months Ended	
	March 31,	
	2017	2016
Loss and LAE incurred	\$ 22,302	\$ 23,489

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Reinsurance recoverables	(602)	(1,530)
Net loss and LAE incurred	\$ 21,700	\$ 21,959

Catastrophic coverage

At March 31, 2017, 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 and/or loss; \$25 million in excess of \$25 million loss; \$25 million in excess of \$50 million loss and \$50 million in excess of \$75 million loss. NLIC and ASIC retain no participation in any of the layers, beyond the first \$8 million and \$1.5 million, respectively. At March 31, 2017, total retention for any one catastrophe that affects both NLIC and ASIC was limited to \$8 million in the aggregate.

Effective January 1, 2017, NLC renewed its underlying excess of loss contract that provides \$10 million aggregate coverage in excess of NLC's per event retention and aggregate retention for sub-catastrophic events. NLC retains no participation beyond the first \$1 million, which is consistent with 2016.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

22. Segment and Related Information

The Company currently has four reportable business segments that are organized primarily by the core products offered to the segments' respective customers. These segments reflect the manner in which operations are managed and the criteria used by the Company's chief operating decision maker function to evaluate segment performance, develop strategy and allocate resources. The chief operating decision maker function consists of the Company's President and Co-Chief Executive Officer and the Company's Vice Chairman and Co-Chief Executive Officer.

The banking segment includes the operations of the Bank. The broker-dealer segment includes the operations of Securities Holdings, while the mortgage origination segment is composed of PrimeLending, and the insurance segment is composed of NLC.

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.

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

	Mortgage					All Other and Hilltop	
Three Months Ended March 31, 2017	Banking	Broker-Dealer Origination	Insurance	Corporate	Eliminations	Consolidated	
Net interest income							
(expense)	\$ 82,082	\$ 8,488	\$ (1,882)	\$ 516	\$ (2,535)	\$ 92,100	
Provision for loan	1,837	(132)	—	—	—	1,705	

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losses							
Noninterest							
income	12,411	82,551	143,638	38,311	1	(5,473)	271,439
Noninterest							
expense	60,814	81,657	131,838	37,013	9,387	(217)	320,492
Income							
(loss) before							
income							
taxes	\$ 31,842	\$ 9,514	\$ 9,918	\$ 1,814	\$ (11,921)	\$ 175	\$ 41,342

	Mortgage					All Other and Hilltop	
Three Months Ended March 31, 2016	Banking	Broker-Dealer	Origination	Insurance	Corporate	Eliminations	Consolidated
Net interest income (expense)	\$ 86,104	\$ 7,051	\$ (2,569)	\$ 740	\$ (1,714)	\$ 4,228	\$ 93,840
Provision for loan losses	3,500	(93)	—	—	—	—	3,407
Noninterest income	12,956	80,882	146,338	41,804	1	(4,606)	277,375
Noninterest expense	64,348	84,261	134,671	36,375	5,849	(315)	325,189
Income (loss) before income taxes	\$ 31,212	\$ 3,765	\$ 9,098	\$ 6,169	\$ (7,562)	\$ (63)	\$ 42,619

	Banking	Broker-Dealer	Mortgage Origination	Insurance	Corporate	All Other and Eliminations	Hilltop Consolidated
March 31, 2017							
Goodwill	\$ 207,741	\$ 7,008	\$ 13,071	\$ 23,988	\$ —	\$ —	\$ 251,808
Total assets	\$ 8,946,648	\$ 2,968,943	\$ 1,568,276	\$ 345,651	\$ 2,066,185	\$ (3,557,276)	\$ 12,338,420
December 31, 2016							
Goodwill	\$ 207,741	\$ 7,008	\$ 13,071	\$ 23,988	\$ —	\$ —	\$ 251,808
	\$ 9,527,518	\$ 2,777,849	\$ 2,042,458	\$ 347,252	\$ 2,032,749	\$ (3,989,764)	\$ 12,738,062

Total
assets

23. 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. Restricted Stock Awards are the only instruments issued by Hilltop 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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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. During the three months ended March 31, 2017 and 2016, RSUs were the only potentially dilutive non-participating instruments issued by Hilltop, while during the three months ended March 31, 2016, stock options and RSUs were potentially dilutive non-participating instruments. Next, the Company determines and includes 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 March 31,	
	2017	2016
Basic earnings per share:		
Income applicable to Hilltop common stockholders	\$ 26,434	\$ 27,567
Less: income applicable to participating shares	(1)	(125)
Net earnings available to Hilltop common stockholders	\$ 26,433	\$ 27,442
Weighted average shares outstanding - basic	98,441	98,153
Basic earnings per common share	\$ 0.27	\$ 0.28
Diluted earnings per share:		
Income applicable to Hilltop common stockholders	\$ 26,434	\$ 27,567
Weighted average shares outstanding - basic	98,441	98,153
Effect of potentially dilutive securities	316	516
Weighted average shares outstanding - diluted	98,757	98,669

Diluted earnings per common share	\$ 0.27	\$ 0.28
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24. Subsequent Event

On April 17, 2017, NLC provided notification to the holder of the \$20.0 million insurance company note payable due March 2035 that NLC would payoff this outstanding debt in June 2017, subject to necessary regulatory approval.

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SCHEDULE I – Insurance Incurred and Cumulative Paid Losses and Allocated Loss Adjustment Expenses,

Net of Reinsurance

(in thousands)

Incurred Losses and Allocated	
Loss Adjustment Expenses,	March
Net of Reinsurance	31, 2017
	Total
	of
	Incurred