Hilltop Holdings Inc.
Form 10-Q
October 26, 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 September 30, 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	84-1477939
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2323 Victory Avenue, Suite 1400

Dallas, TX	75219
(Address of principal executive offices)	(Zip Code)

(214) 855-2177

(Registrant’s telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 (Do not check if a smaller reporting company)	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 October 26, 2017 was 95,910,314.

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HILLTOP HOLDINGS INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2017

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(Unaudited)

	September 30, 2017	December 31, 2016
Assets		
Cash and due from banks	$ 354,569	$ 669,357
Federal funds sold	400	21,407
Securities purchased under agreements to resell	134,654	89,430
Assets segregated for regulatory purposes	207,336	180,993
Securities:		
Trading, at fair value	676,411	265,534
Available for sale, at fair value (amortized cost of $762,984 and $598,198, respectively)	765,542	598,007
Held to maturity, at amortized cost (fair value of $364,122 and $345,088, respectively)	368,031	351,831
	1,809,984	1,215,372
Loans held for sale	1,939,321	1,795,463
Non-covered loans, net of unearned income	6,148,813	5,843,499
Allowance for non-covered loan losses	(58,779)	(54,186)
Non-covered loans, net	6,090,034	5,789,313
Covered loans, net of allowance of $2,141 and $413, respectively	188,269	255,714
Broker-dealer and clearing organization receivables	1,672,123	1,497,741
Premises and equipment, net	176,281	190,361
FDIC indemnification asset	33,143	71,313
Covered other real estate owned	40,343	51,642
Other assets	596,095	613,453
Goodwill	251,808	251,808
Other intangible assets, net	38,440	44,695
Total assets	$ 13,532,800	$ 12,738,062
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	$ 2,279,633	$ 2,199,483
Interest-bearing	5,383,814	4,864,328
Total deposits	7,663,447	7,063,811

Broker-dealer and clearing organization payables	1,517,698	1,347,128
Short-term borrowings	1,477,201	1,417,289
Securities sold, not yet purchased, at fair value	173,509	153,889
Notes payable	300,196	317,912
Junior subordinated debentures	67,012	67,012
Other liabilities	424,381	496,501
Total liabilities	11,623,444	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; 95,904,322 and 98,543,774 shares issued and outstanding at September 30, 2017 and December 31, 2016, respectively	959	985
Additional paid-in capital	1,525,169	1,572,877
Accumulated other comprehensive income	2,585	485
Retained earnings	376,873	295,568
Deferred compensation employee stock trust, net	840	903
Employee stock trust (12,066 and 15,492 shares, at cost, respectively)	(241)	(309)
Total Hilltop stockholders' equity	1,906,185	1,870,509
Noncontrolling interests	3,171	4,011
Total stockholders' equity	1,909,356	1,874,520
Total liabilities and stockholders' equity	$ 13,532,800	$ 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 September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Interest income:				
Loans, including fees	$ 102,546	$ 97,590	$ 306,330	$ 287,591
Securities borrowed	11,404	9,037	29,054	22,952
Securities:				
Taxable	11,157	5,935	27,723	19,136
Tax-exempt	1,471	1,518	4,090	4,692
Other	2,366	1,183	6,294	3,248
Total interest income	128,944	115,263	373,491	337,619
Interest expense:				
Deposits	6,841	3,996	16,995	11,872
Securities loaned	8,935	6,954	22,756	17,857
Short-term borrowings	4,567	1,497	9,633	3,974
Notes payable	2,680	2,793	8,320	7,993
Junior subordinated debentures	774	673	2,229	1,973
Other	167	180	502	543
Total interest expense	23,964	16,093	60,435	44,212
Net interest income	104,980	99,170	313,056	293,407
Provision for loan losses	1,260	3,990	8,818	36,273
Net interest income after provision for loan losses	103,720	95,180	304,238	257,134
Noninterest income:				
Net realized gains on securities	—	—	14	—
Net gains from sale of loans and other mortgage production income	138,498	175,412	416,336	469,721
Mortgage loan origination fees	25,256	26,807	70,788	71,417
Securities commissions and fees	38,735	39,722	115,596	118,481
Investment and securities advisory fees and commissions	25,620	31,129	73,359	84,302
Net insurance premiums earned	34,493	38,747	106,653	117,201
Other	35,875	42,641	131,862	116,716
Total noninterest income	298,477	354,458	914,608	977,838
Noninterest expense:				

Employees' compensation and benefits	209,747	225,194	611,352	625,353
Occupancy and equipment, net	29,073	27,460	84,285	82,264
Loss and loss adjustment expenses	31,234	16,055	86,118	75,225
Policy acquisition and other underwriting expenses	10,917	11,064	33,397	33,632
Other	72,871	84,360	225,433	240,213
Total noninterest expense	353,842	364,133	1,040,585	1,056,687
Income before income taxes	48,355	85,505	178,261	178,285
Income tax expense	18,003	33,017	58,792	65,879
Net income	30,352	52,488	119,469	112,406
Less: Net income attributable to noncontrolling interest	146	556	353	1,833
Income attributable to Hilltop	$ 30,206	$ 51,932	$ 119,116	$ 110,573
Earnings per common share:				
Basic	$ 0.31	$ 0.53	$ 1.22	$ 1.12
Diluted	$ 0.31	$ 0.53	$ 1.22	$ 1.12
Cash dividends declared per common share	$ 0.06	$ —	$ 0.18	$ —
Weighted average share information:				
Basic	96,096	98,490	97,554	98,367
Diluted	96,306	98,625	97,803	98,573

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income	$ 30,352	$ 52,488	$ 119,469	$ 112,406
Other comprehensive income:				
Net unrealized gains (losses) on securities available for sale, net of tax of $263, $(420), $1,190 and $3,004, respectively	473	(743)	2,109	5,410
Reclassification adjustment for gains (losses) included in net income, net of tax of $0, $0, $(5) and $0, respectively	—	—	(9)	—
Comprehensive income	30,825	51,745	121,569	117,816
Less: comprehensive income attributable to noncontrolling interest	146	556	353	1,833
Comprehensive income applicable to Hilltop	$ 30,679	$ 51,189	$ 121,216	$ 115,983

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(in thousands)

(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Deferred Compensation Employee Stock Trust, Net	Employee Stock Trust Shares	Employee Stock Trust Amount	Total Hilltop Stockholders' Equity	Noncontrollin Interest
	98,896	$ 989	$ 1,577,270	$ 2,629	$ 155,475	$ 1,034	22	$ (443)	$ 1,736,954	$ 1,171
	—	—	—	—	110,573	—	—	—	110,573	1,833
e	—	—	—	5,410	—	—	—	—	5,410	—
k	538	5	4,134	—	—	—	—	—	4,139	—
	—	—	7,274	—	—	—	—	—	7,274	—
k d	17	—	325	—	—	—	—	—	325	—
k	(94)	(1)	(2,710)	—	—	—	—	—	(2,711)	—
of k	(816)	(8)	(16,268)	—	—	—	—	—	(16,276)	—
	—	—	—	—	—	(134)	(7)	134	—	—
g	—	—	—	—	—	—	—	—	—	676

,	98,541	$ 985	$ 1,570,025	$ 8,039	$ 266,048	$ 900	15	$ (309)	$ 1,845,688	$ 3,680
,	98,544	$ 985	$ 1,572,877	$ 485	$ 295,568	$ 903	15	$ (309)	$ 1,870,509	$ 4,011
	—	—	—	—	119,116	—	—	—	119,116	353
e	—	—	—	2,100	—	—	—	—	2,100	—
	—	—	8,396	—	—	—	—	—	8,396	—
k d	12	—	327	—	—	—	—	—	327	—
k	264	3	(2,433)	—	—	—	—	—	(2,430)	—
of k	(2,916)	(29)	(53,998)	—	(20,427)	—	—	—	(74,454)	—
k	—	—	—	—	(17,384)	—	—	—	(17,384)	—
	—	—	—	—	—	(63)	(3)	68	5	—
g	—	—	—	—	—	—	—	—	—	(1,193)
,	95,904	$ 959	$ 1,525,169	$ 2,585	$ 376,873	$ 840	12	$ (241)	$ 1,906,185	$ 3,171

See accompanying notes.

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HILLTOP HOLDINGS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2017	2016
Operating Activities		
Net income	$ 119,469	$ 112,406
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	8,818	36,273
Depreciation, amortization and accretion, net	(11,300)	(37,616)
Net realized gains on securities	(14)	—
Deferred income taxes	6,013	4,878
Other, net	8,540	11,661
Net change in securities purchased under agreements to resell	(45,224)	(32,624)
Net change in assets segregated for regulatory purposes	(26,343)	(15,227)
Net change in trading securities	(410,877)	(187,958)
Net change in broker-dealer and clearing organization receivables	(157,908)	149,674
Net change in FDIC indemnification asset	24,637	18,486
Net change in other assets	(35,967)	(50,760)
Net change in broker-dealer and clearing organization payables	223,043	(117,398)
Net change in other liabilities	(100,970)	(1,612)
Net change in securities sold, not yet purchased	19,620	34,589
Proceeds from sale of mortgage servicing rights asset	17,499	7,586
Net gains from sales of loans	(416,336)	(469,721)
Loans originated for sale	(11,251,438)	(11,995,553)
Proceeds from loans sold	11,520,363	12,292,342
Net cash used in operating activities	(508,375)	(240,574)
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	42,185	141,485
Proceeds from sales, maturities and principal reductions of securities available for sale	248,578	367,307
Purchases of securities held to maturity	(58,831)	(175,781)
Purchases of securities available for sale	(415,282)	(250,896)
Net change in loans	(206,362)	(465,542)
Purchases of premises and equipment and other assets	(20,093)	(31,119)
Proceeds from sales of premises and equipment and other real estate owned	27,333	58,490
Net cash received from (paid for) Federal Home Loan Bank and Federal Reserve Bank stock	14,540	(6,807)

Net cash used in investing activities	(367,932)	(362,863)
Financing Activities		
Net change in deposits	547,163	108,834
Net change in short-term borrowings	59,912	317,649
Proceeds from notes payable	285,806	208,794
Payments on notes payable	(303,472)	(134,052)
Proceeds from issuance of common stock	—	4,139
Payments to repurchase common stock	(27,388)	—
Dividends paid on common stock	(17,384)	—
Net cash distributed (to) from noncontrolling interest	(1,193)	676
Taxes paid on employee stock awards netting activity	(2,431)	(2,406)
Other, net	(501)	(704)
Net cash provided by financing activities	540,512	502,930
Net change in cash and cash equivalents	(335,795)	(100,507)
Cash and cash equivalents, beginning of period	690,764	669,445
Cash and cash equivalents, end of period	$ 354,969	$ 568,938
Supplemental Disclosures of Cash Flow Information		
Cash paid for interest	$ 57,504	$ 42,399
Cash paid for income taxes, net of refunds	$ 69,863	$ 53,899
Supplemental Schedule of Non-Cash Activities		
Conversion of loans to other real estate owned	$ 8,319	$ 14,894
Additions to mortgage servicing rights	$ 8,429	$ 20,309

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, headquartered in Dallas, Texas, 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 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 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 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"), which holds an ownership interest in and is the managing member of certain affiliated business arrangements ("ABAs").

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

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 May 2017, FASB issued Accounting Standards Update (“ASU”) 2017-09 which provides clarity and reduces both diversity in practice and cost and complexity associated with changes to the terms or conditions of a share-based payment award and, specifically, which changes require an entity to apply modification accounting. The amendments in this update are 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 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 transition 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 transition method. Early adoption is permitted, however, 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 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, however, 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 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. 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. Early adoption is permitted, however, the Company does not intend to adopt the provisions of the amendment early. The Company is currently evaluating the effects 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 and modifies the required process used to evaluate deferred tax assets on available for sale securities. The amendment is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Upon adoption, the Company will reclassify all equity investments out of trading and available for sale securities, with all subsequent changes in fair value recognized in net income. Additionally, the disclosure of the fair value of the loan portfolio will be presented using an exit price method instead of the current discounted cash flow method. The Company continues to evaluate the impact of ASU 2016-01 on other aspects of its 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 FASB has subsequently issued several amendments to the standard, including clarification of principal versus agent considerations, narrow scope improvements and other technical corrections. The amendments outline 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 amendments also require 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 amendments are 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

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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 has gathered an inventory of contracts with customers and performed an in-depth assessment. The preliminary assessment suggests that the revenue recognition policies within the Company's broker-dealer segment will be affected when adopted. Specifically, the new guidance may require certain advisory and underwriting revenues and expenses to be recorded on a gross basis while the current guidance requires recognizing these revenues net of the related expenses. The Company is still interpreting certain aspects of this new accounting guidance to address certain implementation issues, specifically the impact of any changes to the accounting for mutual fund fees and insurance product sales commissions received throughout the life of the contract. 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.

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 September 30, 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 $1.86 billion and $1.75 billion, respectively, and the unpaid principal balance of those loans was $1.79 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

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

September 30, 2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Trading securities	$ 3,526	$ 672,885	$ —	$ 676,411
Available for sale securities	20,983	744,559	—	765,542
Loans held for sale	—	1,828,275	31,545	1,859,820
Derivative assets	—	55,563	—	55,563
MSR asset	—	—	47,766	47,766
Securities sold, not yet purchased	85,471	88,038	—	173,509
Derivative liabilities	—	17,500	—	17,500

December 31, 2016	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
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

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

				Total Gains or Losses (Realized or Unrealized)		
	Balance at Beginning of Period	Purchases/ Additions	Sales/ Reductions	Included in Net Income	Included in Other Comprehensive Income (Loss)	Balance at End of Period
Three months ended September 30, 2017						
Loans held for sale	$ 30,037	$ 8,881	$ (5,685)	$ (1,688)	$ —	$ 31,545
MSR asset	43,580	5,939	—	(1,753)	—	47,766
Total	$ 73,617	$ 14,820	$ (5,685)	$ (3,441)	$ —	$ 79,311
Nine months ended September 30, 2017						
Loans held for sale	$ 35,801	$ 25,384	$ (23,108)	$ (6,532)	$ —	$ 31,545
MSR asset	61,968	8,429	(17,499)	(5,132)	—	47,766
Total	$ 97,769	$ 33,813	$ (40,607)	$ (11,664)	$ —	$ 79,311
Three months ended September 30, 2016						
Trading securities	$ 1	$ —	$ —	$ (1)	$ —	$ —
Loans held for sale	45,645	8,066	(8,686)	(2,448)	—	42,577
MSR asset	33,491	10,416	—	(156)	—	43,751
Total	$ 79,137	$ 18,482	$ (8,686)	$ (2,605)	$ —	$ 86,328
Nine months ended September 30, 2016						
Trading securities	$ 1	$ —	$ —	$ (1)	$ —	$ —
Loans held for sale	25,880	51,105	(23,817)	(10,591)	—	42,577
MSR asset	52,285	20,309	(7,586)	(21,257)	—	43,751
Total	$ 78,166	$ 71,414	$ (31,403)	$ (31,849)	$ —	$ 86,328

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 September 30, 2017.

For Level 3 financial instruments measured at fair value on a recurring basis at September 30, 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	90 - 95 % (95 %)
MSR asset	Discounted cash flows	Constant prepayment rate	10.85 %
		Discount rate	11.07 %

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 inputs. The fair values of such loans are 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.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 September 30, 2017			Three Months Ended September 30, 2016		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	$ (4,443)	$ —	$ (4,443)	$ 73	$ —	$ 73
MSR asset	(1,753)	—	(1,753)	(156)	—	(156)

	Nine Months Ended September 30, 2017			Nine Months Ended September 30, 2016		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale	$ 26,650	$ —	$ 26,650	$ 16,003	$ —	$ 16,003
MSR asset	(5,132)	—	(5,132)	(21,257)	—	(21,257)

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

Impaired Loans — The Company reports impaired loans based on the underlying fair value of the collateral through specific allowances within the allowance for loan losses. Purchased credit impaired (“PCI”) loans with a fair value of $172.9 million, $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 September 30, 2017, estimates for these significant unobservable inputs were as follows.

	PCI Loans PlainsCapital Merger		FNB Transaction		SWS Merger	
Weighted average default rate	64	%	45	%	59	%
Weighted average loss severity rate	66	%	18	%	29	%
Weighted average prepayment speed	0	%	8	%	0	%

At September 30, 2017, the resulting weighted average expected loss on PCI loans associated with the PlainsCapital Merger, FNB Transaction and SWS Merger was 43%, 8% and 17%, 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.

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 September 30, 2017, the most significant

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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 September 30, 2017 and December 31, 2016, the estimated fair value of covered OREO was $40.3 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 September 30, 2017 and December 31, 2016 was $4.8 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 Three Months Ended September 30,		Total Gains (Losses) for the Nine Months Ended September 30,	
September 30, 2017	Inputs	Inputs	Inputs	Fair Value	2017	2016	2017	2016
Non-covered impaired loans	$ —	$ —	$ 42,953	$ 42,953	$ 793	$ 1,149	$ 323	$ 1,284
Covered impaired loans	—	—	58,490	58,490	(787)	725	(1,764)	815
Non-covered other real estate owned	—	3,512	—	3,512	(135)	(427)	(258)	(439)
Covered other real estate owned	—	6,969	—	6,969	(388)	(2,552)	(2,523)	(14,284)

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. There have been no changes to the methods for determining estimated fair value for financial assets and liabilities which are described in detail in Note 3 to the consolidated financial statements included in the Company’s 2016 Form 10-K.

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

		Estimated Fair Value			
September 30, 2017	Carrying Amount	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
Financial assets:					
Cash and cash equivalents	$ 354,969	$ 354,969	$ —	$ —	$ 354,969
Securities purchased under agreements to resell	134,654	—	134,654	—	134,654
Assets segregated for regulatory purposes	207,336	207,336	—	—	207,336
Held to maturity securities	368,031	—	364,122	—	364,122
Loans held for sale	79,501	—	79,501	—	79,501
Non-covered loans, net	6,090,034	—	485,604	5,802,891	6,288,495
Covered loans, net	188,269	—	—	284,424	284,424
Broker-dealer and clearing organization receivables	1,672,123	—	1,672,123	—	1,672,123
FDIC indemnification asset	33,143	—	—	22,866	22,866
Other assets	64,907	—	59,300	5,607	64,907
Financial liabilities:					
Deposits	7,663,447	—	7,662,392	—	7,662,392
Broker-dealer and clearing organization payables	1,517,698	—	1,517,698	—	1,517,698
Short-term borrowings	1,477,201	—	1,477,201	—	1,477,201
Debt	367,208	—	364,731	—	364,731
Other liabilities	6,630	—	6,630	—	6,630

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Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

4. Securities

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

	September 30, 2017	December 31, 2016
U.S. Treasury securities	$ 200	$ 5,940
U.S. government agencies:		
Bonds	53,275	36,303
Residential mortgage-backed securities	407,275	2,539
Commercial mortgage-backed securities	9,599	15,171
Collateralized mortgage obligations	1,098	5,607
Corporate debt securities	77,435	60,699
States and political subdivisions	90,144	89,946
Unit investment trusts	31,626	41,409
Private-label securitized product	2,398	4,292
Other	3,361	3,628
Totals	$ 676,411	$ 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 obligations 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 $173.5 million and $153.9 million at September 30, 2017 and December 31, 2016, respectively.

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Hilltop Holdings Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Unaudited)

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

	Available for Sale			
September 30, 2017	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. Treasury securities	$ 22,751	$ 168	$ (39)	$ 22,880
U.S. government agencies:				
Bonds	100,289	851	(133)	101,007
Residential mortgage-backed securities	247,272	940	(2,304)	245,908
Commercial mortgage-backed securities	12,091	78	(24)	12,145
Collateralized mortgage obligations	222,187	203	(2,656)	219,734
Corporate debt securities	72,266	2,489	(2)	74,753
States and political subdivisions	66,173	1,493	(39)	67,627
Commercial mortgage-backed securities	499	6	—	505
Equity securities	19,456	1,532	(5)	20,983
Totals	$ 762,984	$ 7,760	$ (5,202)	$ 765,542

	Available for Sale			
December 31, 2016	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
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

September 30, 2017	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government agencies:				
Bonds	$ 40,515	$ 28	$ (891)	$ 39,652
Residential mortgage-backed securities	16,973	198	—	17,171
Commercial mortgage-backed securities	71,613	404	(510)	71,507
Collateralized mortgage obligations	183,926	152	(2,550)	