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

Dallas, TX 75201
(Address of principal executive offices) (Zip Code)

(214) 855-2177

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 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

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

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)

	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	Noncontrolling Interest	T S E
1,	98,896	$ 989	$ 1,577,270	$ 2,629	$ 155,475	$ 1,034	22	$ (443)	$ 1,736,954	$ 1,171	$
	—	—	—	—	27,567	—	—	—	27,567	629	
ive	—	—	—	4,249	—	—	—	—	4,249	—	
ck	500	5	3,845	—	—	—	—	—	3,850	—	
on	—	—	2,228	—	—	—	—	—	2,228	—	
ock ard	6	—	108	—	—	—	—	—	108	—	
ck	(1)	—	(33)	—	—	—	—	—	(33)	—	
of ck	(816)	(8)	(16,268)	—	—	—	—	—	(16,276)	—	
on	—	—	—	—	—	(14)	(1)	15	1	—	
o ng	—	—	—	—	—	—	—	—	—	(437)	
	98,585	$ 986	$ 1,567,150	$ 6,878	$ 183,042	$ 1,020	21	$ (428)	$ 1,758,648	$ 1,363	$

arch											
1,	98,544	$ 985	$ 1,572,877	$ 485	$ 295,568	$ 903	15	$ (309)	$ 1,870,509	$ 4,011	$
	—	—	—	—	26,434	—	—	—	26,434	(127)	
ive	—	—	—	412	—	—	—	—	412	—	
on	—	—	2,577	—	—	—	—	—	2,577	—	
ock ard	3	—	105	—	—	—	—	—	105	—	
ck	122	2	(1,031)	—	—	—	—	—	(1,029)	—	
of ck	(262)	(3)	(4,199)	—	(3,003)	—	—	—	(7,205)	—	
n ck	—	—	—	—	(5,802)	—	—	—	(5,802)	—	
on	—	—	—	—	—	(10)	—	9	(1)	—	
o ng	—	—	—	—	—	—	—	—	—	(575)	
arch	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)

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 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).

March 31, 2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
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

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

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 March 31, 2017						
Loans held for sale	$ 35,801	$ 7,828	$ (10,701)	$ (2,714)	$ —	$ 30,214

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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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 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	$ 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).

					Total Gains (Losses) for the Three Months Ended March 31,	
March 31, 2017	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value	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).

		Estimated Fair Value			
March 31, 2017	Carrying Amount	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
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

		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

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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).

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

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			
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			
March 31, 2017	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
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			
December 31, 2016	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
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

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 Number of Securities	Fair Value	Unrealized Losses	December 31, 2016 Number of Securities	Fair Value	Unrealized Losses
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

	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		Held to Maturity	
	Amortized Cost	Fair Value	Amortized 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				