

Hilltop Holdings Inc.  
Form 10-K  
February 15, 2019  
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended: December 31, 2018

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

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.)

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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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value \$0.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	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

Aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2018, was approximately \$1.58 billion. For the purposes of this computation, all officers, directors and 10% stockholders are considered affiliates. The number of shares of the registrant’s common stock outstanding at February 14, 2019 was 93,611,624.

#### DOCUMENTS INCORPORATED BY REFERENCE

The Registrant’s definitive Proxy Statement pertaining to the 2019 Annual Meeting of Stockholders, filed or to be filed not later than 120 days after the end of the fiscal year pursuant to Regulation 14A, is incorporated herein by reference into Part III.

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Table of Contents

## TABLE OF CONTENTS

MARKET AND INDUSTRY DATA AND FORECASTSFORWARD-LOOKING STATEMENTSPART I

<u>Item 1.</u>	<u>Business</u>	5
<u>Item 1A.</u>	<u>Risk Factors</u>	29
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	51
<u>Item 2.</u>	<u>Properties</u>	51
<u>Item 3.</u>	<u>Legal Proceedings</u>	52
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	52

PART II

<u>Item 5.</u>	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	52
<u>Item 6.</u>	<u>Selected Financial Data</u>	54
<u>Item 7.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	56
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	100
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	103
<u>Item 9.</u>	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	103
<u>Item 9A.</u>	<u>Controls and Procedures</u>	103
<u>Item 9B.</u>	<u>Other Information</u>	104

PART III

<u>Item 10.</u>	<u>Directors, Executive Officers and Corporate Governance</u>	105
<u>Item 11.</u>	<u>Executive Compensation</u>	105
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	105
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u>	105
<u>Item 14.</u>	<u>Principal Accounting Fees and Services</u>	105

PART IV

<u>Item 15.</u>	<u>Exhibits, Financial Statement Schedules</u>	106
<u>Item 16.</u>	<u>Form 10-K Summary</u>	106

MARKET AND INDUSTRY DATA AND FORECASTS

Market and industry data and other statistical information and forecasts used throughout this Annual Report on Form 10-K (this “Annual Report”) are based on independent industry publications, government publications and reports by market research firms or other published independent sources. We have not sought or obtained the approval or endorsement of the use of this third party information. Some data also is based on our good faith estimates, which are derived from our review of internal surveys, as well as independent sources. Forecasts are particularly likely to be inaccurate, especially over long periods of time.

## Table of Contents

Unless the context otherwise indicates, all references in this Annual Report to the “Company,” “we,” “us,” “our” or “ours” or similar words are to Hilltop Holdings Inc. and its direct and indirect wholly owned subsidiaries, references to “Hilltop” refer solely to Hilltop Holdings Inc., references to “PCC” refer to PlainsCapital Corporation (a wholly owned subsidiary of Hilltop), references to “Securities Holdings” refer to Hilltop Securities Holdings LLC (a wholly owned subsidiary of Hilltop), references to “Hilltop Securities” refer to Hilltop Securities Inc. (a wholly owned subsidiary of Securities Holdings), references to “HTS Independent Network” refer to Hilltop Securities Independent Network Inc. (a wholly owned subsidiary of Securities Holdings), references to the “Bank” refer to PlainsCapital Bank (a wholly owned subsidiary of PCC), references to “FNB” refer to First National Bank, references to “SWS” refer to the former SWS Group, Inc., references to “First Southwest” refer to First Southwest Holdings, LLC (a wholly owned subsidiary of Securities Holdings) and its subsidiaries as a whole, references to “FSC” refer to First Southwest Company, LLC (a former wholly owned subsidiary of First Southwest), references to “PrimeLending” refer to PrimeLending, a PlainsCapital Company (a wholly owned subsidiary of the Bank) and its subsidiaries as a whole, references to “NLC” refer to National Lloyds Corporation (a wholly owned subsidiary of Hilltop) and its subsidiaries as a whole, references to “NLIC” refer to National Lloyds Insurance Company (a wholly owned subsidiary of NLC) and references to “ASIC” refer to American Summit Insurance Company (a wholly owned subsidiary of NLC).

## FORWARD-LOOKING STATEMENTS

This Annual Report and the documents incorporated by reference into this report include “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”), as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this Annual Report that address results or developments that we expect or anticipate will or may occur in the future, and statements that are preceded by, followed by or include, words such as “anticipates,” “believes,” “could,” “estimates,” “expects,” “forecasts,” “goal,” “intends,” “might,” “plan,” “probable,” “projects,” “seeks,” “should,” “target,” “view” or “would” or the negative of these words and phrases or similar words or phrases, including such things as our business strategy, our financial condition, our efforts to make, and the timing of, strategic acquisitions, the costs of integrating the operations of acquired businesses, our revenue, our liquidity and sources of funding, market trends, operations and business, taxes, information technology expenses, capital levels, mortgage servicing rights (“MSR”) assets, stock repurchases, dividend payments, expectations concerning mortgage loan origination volume and interest rate compression, expected levels of refinancing as a percentage of total loan origination volume, projected losses on mortgage loans originated, projected municipal issuance volume, loss estimates related to natural disasters, construction costs, total expenses and cost savings expected from PrimeLending’s cost reduction efforts, the effects of government regulation applicable to our operations, the appropriateness of, and changes in, our allowance for loan losses and provision for loan losses, anticipated investment yields, our expectations regarding accretion of discount on loans in future periods, the collectability of loans, cybersecurity incidents and the outcome of litigation are forward-looking statements.

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

the credit risks of lending activities, including our ability to estimate loan losses as well as the effects of changes in the level of, and trends in, loan delinquencies and write-offs;

changes in the interest rate environment;

changes in general economic, market and business conditions in areas or markets where we compete, including changes in the price of crude oil;

· risks associated with our concentration in real estate related loans;  
effectiveness of our data security controls in the face of cyber attacks;

severe catastrophic events in Texas and other areas of the southern United States;

3

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Table of Contents

- the effects of our indebtedness on our ability to manage our business successfully, including the restrictions imposed by the indenture governing our indebtedness;
- cost and availability of capital;
  - changes in state and federal laws, regulations or policies affecting one or more of our business segments, including changes in regulatory fees, deposit insurance premiums, capital requirements and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”);
  - changes in key management;
  - competition in our banking, broker-dealer, mortgage origination and insurance segments from other banks and financial institutions as well as investment banking and financial advisory firms, mortgage bankers, asset-based non-bank lenders, government agencies and insurance companies;
  - legal and regulatory proceedings;
  - failure of our insurance segment reinsurers to pay obligations under reinsurance contracts;
  - risks associated with merger and acquisition integration; and
  - our ability to use excess capital in an effective manner.

For a more detailed discussion of these and other factors that may affect our business and that could cause the actual results to differ materially from those anticipated in these forward-looking statements, see Item 1A, “Risk Factors,” and Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” herein.

We caution that the foregoing list of factors is not exhaustive, and new factors may emerge, or changes to the foregoing factors may occur, that could impact our business. All subsequent written and oral forward-looking statements concerning our business attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements above. We do not undertake any obligation to update any forward-looking statement, whether written or oral, relating to the matters discussed in this Annual Report except to the extent required by federal securities laws.

Table of Contents

PART I

Item 1. Business.

General

Hilltop Holdings Inc. is a diversified, Texas-based financial holding company registered under the Bank Holding Company Act of 1956, as amended (the “Bank Holding Company Act”). Our primary line of business is to provide business and consumer banking services from offices located throughout Texas through the Bank. We also provide an array of financial products and services through our broker-dealer, mortgage origination and insurance segments. We endeavor to build and maintain a strong financial services company through organic growth as well as acquisitions, which we may make using available capital, excess liquidity and, if necessary or appropriate, additional equity or debt financing sources. The following includes additional details regarding the financial products and services provided by each of our primary business units.

PCC. PCC is a financial holding company that provides, through its subsidiaries, traditional banking and wealth, investment and treasury management services primarily in Texas and residential mortgage loans throughout the United States.

On August 1, 2018, we acquired privately-held, Houston-based The Bank of River Oaks (“BORO”) in an all-cash transaction (the “BORO Acquisition”). In connection with the acquisition, we merged BORO into the Bank, and all customer accounts were converted to the PlainsCapital Bank platform.

Securities Holdings. 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. 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.



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At December 31, 2018, on a consolidated basis, we had total assets of \$13.7 billion, total deposits of \$8.5 billion, total loans, including loans held for sale, of \$8.3 billion and stockholders' equity of \$2.0 billion.

Our common stock is listed on the New York Stock Exchange ("NYSE") under the symbol "HTH."

Our principal office is located at 2323 Victory Avenue, Suite 1400, Dallas, Texas 75219, and our telephone number at that location is (214) 855-2177. Our internet address is [www.hilltop-holdings.com](http://www.hilltop-holdings.com). Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act are available on our website at <http://ir.hilltop-holdings.com/> under the tab "SEC Filings" as soon as reasonably practicable after we electronically file such reports with, or furnish them to, the Securities and Exchange Commission (the "SEC"). The references to our website in this Annual Report are inactive textual references only. The information on our website is not incorporated by reference into this Annual Report.

## Table of Contents

### Organizational Structure

Our organizational structure is comprised of three primary business units: PCC (banking and mortgage origination); Securities Holdings (broker-dealer); and NLC (insurance). The following graphic provides additional details regarding our current organizational structure.

### Geographic Dispersion of our Businesses

The Bank provides traditional banking and wealth, investment and treasury management services. The Bank has a presence in every major market in Texas and conducts substantially all of its banking operations in Texas.

Our broker-dealer services are provided through Hilltop Securities and HTS Independent Network, which conduct business nationwide. Public finance department net revenues represented 13% of total broker-dealer net revenues during 2018, and 70% of such public finance net revenues were from entities located in Texas. Additionally, retail brokerage service net revenues represented 30% of total broker-dealer net revenues during 2018, and 91% of such retail brokerage service revenues were generated through locations in Texas, California and Oklahoma.

PrimeLending provides residential mortgage origination products and services from over 300 locations in 44 states. During 2018, an aggregate of 62.5% of PrimeLending's origination volume was concentrated in ten states, with 37.5% concentrated in Texas, California and Florida, collectively. Other than these ten states, none of the states in which PrimeLending operated during 2018 represented more than 3% of PrimeLending's origination volume.

Our insurance products are distributed through a broad network of independent agents. During 2018, total gross premiums written were concentrated in five states (Texas, Arizona, Tennessee, Oklahoma and Georgia), with Texas insureds representing 68.2% of the aggregate. None of the other states in which we operated during 2018 had gross premiums written of 3% or more.

### Business Segments

Under accounting principles generally accepted in the United States (“GAAP”), our business units are comprised of four reportable business segments organized primarily by the core products offered to the segments’ respective customers: banking, broker-dealer, mortgage origination and insurance. These segments reflect the manner in which operations are managed and the criteria used by our chief operating decision maker function to evaluate segment performance, develop strategy and allocate resources. Our chief operating decision maker function consists of our President and Co-Chief Executive Officer and our Vice Chairman and Co-Chief Executive Officer.

Corporate includes certain activities not allocated to specific business segments. These activities include holding company financing and investing activities, merchant banking investment opportunities, and management and administrative services to support the overall operations of the Company. Hilltop’s merchant banking investment activities include the

Table of Contents

identification of attractive opportunities for capital deployment in companies engaged in non-financial activities through its merchant bank subsidiary, Hilltop Opportunity Partners LLC, formerly known as PlainsCapital Equity, LLC.

For more financial information about each of our business segments, see Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” herein. See also Note 30 in the notes to our consolidated financial statements included under Item 8, “Financial Statements and Supplementary Data.”

## Banking

The banking segment includes the operations of the Bank, which, at December 31, 2018, had \$10.0 billion in assets and total deposits of \$8.2 billion. The primary sources of our deposits are residents and businesses located in Texas. At December 31, 2018, the Bank employed approximately 1,200 people.

The table below sets forth a distribution of the banking segment’s loans, classified by portfolio segment and segregated between those considered to be purchased credit impaired (“PCI”) loans and all other originated or acquired loans at December 31, 2018 (dollars in thousands). PCI loans showed evidence of credit deterioration at the time of acquisition that made it probable that all contractually required principal and interest payments would not be collected. The commercial and industrial loans category includes \$2.3 billion in warehouse lines of credit extended to PrimeLending, of which \$1.2 billion was drawn at December 31, 2018. Amounts advanced against the warehouse line of credit are included in the table below, but are eliminated from net loans on our consolidated balance sheets.

	Loans, excluding PCI Loans	PCI Loans	Total Loans Held for Investment	% of Total Loans Held for Investment	
Commercial real estate:					
Non-owner occupied	\$ 1,709,533	\$ 13,089	\$ 1,722,622	22.8	%
Owner occupied	1,202,874	14,624	1,217,498	16.1	%
Commercial and industrial	2,695,408	6,559	2,701,967	35.8	%
Construction and land development	932,445	464	932,909	12.4	%
1-4 family residential	623,400	58,327	681,727	9.0	%
Mortgage warehouse	243,806	—	243,806	3.2	%
Consumer	47,537	9	47,546	0.6	%
Total loans held for investment	\$ 7,455,003	\$ 93,072	\$ 7,548,075	100.0	%

The loans acquired in the FDIC-assisted transaction in which we assumed substantially all of the liabilities and acquired substantially all of the assets of FNB (the “FNB Transaction”) were previously subject to loss-share agreements with the FDIC. At the close of business on September 30, 2018, the loss-share agreements for commercial assets with the FDIC expired, except for certain obligations on the part of the Bank that survived. On October 17, 2018, the Bank and the FDIC entered into a Termination Agreement pursuant to which all rights and obligations of the Bank and the FDIC under the FDIC loss-share agreements have been resolved and terminated. Accordingly, loans which were previously referred to as either “covered loans” if covered by the loss-share agreements or otherwise “non-covered loans” are now collectively referred to as “loans held for investment.”

Our lending policies seek to establish an asset portfolio that will provide a return on stockholders’ equity sufficient to maintain capital to assets ratios that meet or exceed established regulations. In support of that goal, we have designed our underwriting standards to determine:

- that our borrowers possess sound ethics and competently manage their affairs;
- that we know the source of the funds the borrower will use to repay the loan;
- that the purpose of the loan makes economic sense; and
- that we identify relevant risks of the loan and determine that the risks are acceptable.

We implement our underwriting standards according to the facts and circumstances of each particular loan request, as discussed below.

Business Banking. Our business banking customers primarily consist of agribusiness, energy, health care, institutions of higher education, real estate (including construction and land development) and wholesale/retail trade companies. We provide these customers with extensive banking services, such as online banking, business check cards and other add-on

## Table of Contents

services as determined on a customer-by-customer basis. Our treasury management services, which are designed to reduce the time, burden and expense of collecting, transferring, disbursing and reporting cash, are also available to our business customers. We offer our business banking customers lines of credit, equipment loans and leases, letters of credit, agricultural loans, commercial real estate loans and other loan products.

Commercial and industrial loans are primarily made within Texas and are underwritten on the basis of the borrower's ability to service the debt from cash flow from an operating business. In general, commercial and industrial loans involve more credit risk than residential and commercial real estate loans and, therefore, usually yield a higher return. The increased risk in commercial and industrial loans results primarily from the type of collateral securing these loans, which typically includes commercial real estate, accounts receivable, equipment and inventory. Additionally, increased risk arises from the expectation that commercial and industrial loans generally will be serviced principally from operating cash flow of the business, and such cash flows are dependent upon successful business operations. Historical trends have shown these types of loans to have higher delinquencies than mortgage loans. As a result of the additional risk and complexity associated with commercial and industrial loans, such loans require more thorough underwriting and servicing than loans to individuals. To manage these risks, our policy is to attempt to secure commercial and industrial loans with both the assets of the borrowing business and other additional collateral and guarantees that may be available. In addition, depending on the size of the credit, we actively monitor the financial condition of the borrower by analyzing the borrower's financial statements and assessing certain financial measures, including cash flow, collateral value and other appropriate credit factors. We also have processes in place to analyze and evaluate on a regular basis our exposure to industries, products, market changes and economic trends.

The Bank offers term financing on commercial real estate that includes retail, office, multi-family, industrial and warehouse properties. Commercial mortgage lending can involve high principal loan amounts, and the repayment of these loans is dependent, in large part, on a borrower's ongoing business operations or on income generated from the properties that are leased to third parties. Accordingly, we apply the measures described above for commercial and industrial loans to our commercial real estate lending, with increased emphasis on analysis of collateral values. As a general practice, the Bank requires its commercial mortgage loans to (i) be secured with first lien positions on the underlying property, (ii) maintain adequate equity margins, (iii) be serviced by businesses operated by an established management team and (iv) be guaranteed by the principals of the borrower. The Bank seeks lending opportunities where cash flow from the collateral provides adequate debt service coverage and/or the guarantor's net worth is comprised of assets other than the project being financed.

The Bank also offers construction financing for (i) commercial, retail, office, industrial, warehouse and multi-family developments, (ii) residential developments and (iii) single family residential properties. Construction loans involve additional risks because loan funds are advanced upon the security of a project under construction, and the project is of uncertain value prior to its completion. If the Bank is forced to foreclose on a project prior to completion, it may not be able to recover the entire unpaid portion of the loan. Additionally, the Bank may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan-to-value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. The Bank generally requires that the subject property of a

construction loan for commercial real estate be pre-leased because cash flows from the completed project provide the most reliable source of repayment for the loan. Loans to finance these projects are generally secured by first liens on the underlying real property. The Bank conducts periodic completion inspections, either directly or through an agent, prior to approval of periodic draws on these loans.

In addition to the real estate lending activities described above, a portion of the Bank's real estate portfolio consists of one-to-four family residential mortgage loans typically collateralized by owner occupied properties located in its market areas. These residential mortgage loans are generally secured by a first lien on the underlying property and have maturities up to 30 years. These loans are shown in the loans held for investment table above as "1-4 family residential."

The Bank's mortgage warehouse lending activities consist of asset-based lending in which the Bank provides short-term, revolving lines of credit to independent mortgage bankers ("IMBs"). IMBs are generally small businesses, with mortgage loan origination and servicing as their sole or primary business. IMBs use the funds from their lines of credit to provide home loans to prospective and existing homeowners. When the IMBs subsequently sell the loans to institutional investors

## Table of Contents

in the secondary market—typically within 30 days of closing the transaction—they use the money received from the sale of the mortgage to replenish their lines of credit.

**Personal Banking.** The Bank offers a broad range of personal banking products and services for individuals. Similar to its business banking operations, the Bank also provides its personal banking customers with a variety of add-on features such as check cards, safe deposit boxes, online banking, bill pay, overdraft privilege services and access to automated teller machine (ATM) facilities throughout the United States. The Bank offers a variety of deposit accounts to its personal banking customers including savings, checking, interest-bearing checking, money market and certificates of deposit.

The Bank loans to individuals for personal, family and household purposes, including lines of credit, home improvement loans, home equity loans, and loans for purchasing and carrying securities. At December 31, 2018, the Bank had \$47.5 million of loans for these purposes, which are shown in the loans held for investment table above as “Consumer.”

**Wealth and Investment Management.** The Bank’s private banking team personally assists high net worth individuals and their families with their banking needs, including depository, credit, asset management, and trust and estate services. The Bank offers trust and asset management services in order to assist these customers in managing, and ultimately transferring, their wealth.

The Bank’s wealth management services provide personal trust, investment management and employee benefit plan administration services, including estate planning, management and administration, investment portfolio management, employee benefit accounts and individual retirement accounts.

## Broker-Dealer

The “Hilltop Broker-Dealers” include the operations of Hilltop Securities, a clearing broker-dealer subsidiary registered with the SEC and the Financial Industry Regulatory Authority (“FINRA”) and a member of the NYSE, HTS Independent Network, an introducing broker-dealer subsidiary that is also registered with the SEC and FINRA, and Hilltop Securities Asset Management, LLC, formerly known as First Southwest Asset Management, LLC, a wholly-owned subsidiary of First Southwest Holdings, LLC. Hilltop Securities and HTS Independent Network are both registered with the Commodity Futures Trading Commission (“CFTC”) as non-guaranteed introducing brokers and as members of the National Futures Association (“NFA”). Additionally, Hilltop Securities Asset Management, LLC, Hilltop Securities and HTS Independent Network are investment advisers registered under the Investment Advisers Act of 1940. At December 31, 2018, Hilltop Securities had consolidated assets of \$3.2 billion and net capital of \$194.0 million, which was \$183.1 million in excess of its minimum net capital requirement of \$10.9 million. At December 31, 2018, the Hilltop Broker-Dealers employed approximately 800 people and maintained 53 locations in 20 states.



Our broker-dealer segment has six primary lines of business: (i) public banking, (ii) capital markets, (iii) retail, (iv) structured finance, (v) clearing services, and (vi) securities lending.

**Public Banking.** Through its public finance and continuing disclosure departments, the public banking line of business assists public bodies nationwide, including cities, counties, school districts, utility districts, tax increment zones, special districts, state agencies and other governmental entities, in originating, syndicating and distributing securities of municipalities and political subdivisions. In addition, the public banking line of business provides specialized advisory and investment banking services for airports, convention centers, healthcare institutions, institutions of higher education, housing, industrial development agencies, toll road authorities, and public power and utility providers. The public finance and continuing disclosure departments generated 82% of the total public banking business line's net revenues for the year-ended December 31, 2018.

Additionally, through its arbitrage, treasury management and government investment pools management departments, the public banking line of business provides state and local governments with advice and assistance with respect to arbitrage rebate compliance, portfolio management and local government investment pool administration.

**Capital Markets.** The capital markets line of business specializes in trading and underwriting U.S. government and government agency bonds, corporate bonds, municipal bonds, mortgage-backed, asset-backed and commercial mortgage-backed securities and structured products to support sales and other customer activities, and trades equities and option orders on an agency basis on behalf of its retail and institutional clients, including corporations, insurance companies, banks, mutual funds, money managers and other clients. In addition, the capital markets group provides asset and liability

## Table of Contents

management advisory services to community banks. The equity trading department focuses on executing equity and option orders on an agency basis for clients, while the syndicate department, housed within its fixed income sales group, coordinates the distribution of managed and co-managed corporate equity underwritings, accepts invitations to participate in competitive or negotiated underwritings managed by other investment banking firms and allocates and markets the sales of allotments to institutional clients and to other broker-dealers.

Retail. The retail line of business acts as a securities broker for retail investors in the purchase and sale of securities, options, commodities and futures contracts that are traded on various exchanges or in the over-the-counter market through our employee-registered representatives or independent contractor arrangements. We extend margin credit on a secured basis to our retail customers in order to facilitate securities transactions. Through Southwest Insurance Agency, Inc. and Southwest Financial Insurance Agency, Inc., we hold insurance licenses to facilitate the sale of insurance and annuity products by Hilltop Securities and HTS Independent Network advisors to retail clients. We retain no underwriting risk related to these insurance and annuity products. In addition, through our investment management team, the retail group provides a number of advisory programs that offer advisors a wide array of products and services for their advisory businesses. In most cases, we charge commissions to our clients in accordance with an established commission schedule, subject to certain discounts based upon the client's level of business, the trade size and other relevant factors. The HTS Independent Network advisors may also contract directly with third party carriers to sell specified insurance products to their customers. The commissions received from these third party carriers are paid directly to the advisor. Hilltop Securities is also a fully disclosed client of two of the largest futures commission merchants in the United States. At December 31, 2018, we employed 124 registered representatives in 17 retail brokerage offices and had contracts with 208 independent retail representatives for the administration of their securities business.

Structured Finance. The structured finance line of business provides structured asset and liability services and commodity hedging advisory services to facilitate balance sheet management primarily to clients of the public finance department. In addition, the structured finance line of business participates in programs in which it issues forward purchase commitments of mortgage-backed securities to certain non-profit housing clients and sells U.S. Agency to-be-announced ("TBA") mortgage-backed securities.

Clearing Services. The clearing services line of business offers fully disclosed clearing services to FINRA- and SEC-registered member firms for trade execution and clearance as well as back office services such as record keeping, trade reporting, accounting, general back-office support, securities and margin lending, reorganization assistance and custody of securities. At December 31, 2018, we provided services to 152 financial organizations, including correspondent firms, correspondent broker-dealers, registered investment advisers, discount and full-service brokerage firms, and institutional firms.

Securities Lending. The securities lending line of business performs activities that include borrowing and lending securities for other broker-dealers, lending institutions, and internal clearing and retail operations. These activities involve borrowing securities to cover short sales and to complete transactions in which clients have failed to deliver securities by the required settlement date, and lending securities to other broker-dealers for similar purposes.

## Mortgage Origination

Our mortgage origination segment operates through a wholly owned subsidiary of the Bank, PrimeLending, which is a residential mortgage banker licensed to originate and close loans in all 50 states and the District of Columbia. PrimeLending primarily originates its mortgage loans through a retail channel, with limited lending through its affiliated business arrangements (“ABAs”). During 2018, funded loan volume through ABAs was approximately 6% of the mortgage origination segment’s total loan volume. At December 31, 2018, our mortgage origination segment operated from over 300 locations in 44 states, originating 19.0%, 11.0% and 7.5%, respectively, of its mortgage loans (by dollar volume) from its Texas, California and Florida locations. The mortgage lending business is subject to variables that can impact loan origination volume, including seasonal and interest rate fluctuations. Historically, the mortgage origination segment has typically experienced increased loan origination volume from purchases of homes during the spring and summer, when more people tend to move and buy or sell homes. An increase in mortgage interest rates tends to result in decreased loan origination volume from refinancings, while a decrease in mortgage interest rates tends to result in increased loan origination volume from refinancings. Changes in interest rates have historically had a lesser impact on home purchases volume than on refinancing volume.

## Table of Contents

PrimeLending handles loan processing, underwriting and closings in-house. Mortgage loans originated by PrimeLending are funded through warehouse lines of credit maintained with the Bank. PrimeLending sells substantially all mortgage loans it originates to various investors in the secondary market, the majority servicing released. PrimeLending's determination of whether to retain or release servicing on mortgage loans it sells is impacted by, among other things, changes in mortgage interest rates, and refinancing and market activity. PrimeLending may, from time to time, manage its related mortgage servicing rights ("MSR") assets through different strategies, including varying the percentage of mortgage loans sold servicing released and opportunistically selling MSR assets. As mortgage loans are sold in the secondary market, PrimeLending pays down its warehouse lines of credit with the Bank. Loans sold are subject to certain standard indemnification provisions with investors, including the repurchase of loans sold and the repayment of sales proceeds to investors under certain conditions.

Our mortgage lending underwriting strategy, driven in large measure by secondary market investor standards, seeks primarily to originate conforming loans. Our underwriting practices include:

- granting loans on a sound and collectible basis;
- obtaining a balance between maximum yield and minimum risk;
- ensuring that primary and secondary sources of repayment are adequate in relation to the amount of the loan; and
- ensuring that each loan is properly documented and, if appropriate, adequately insured.

PrimeLending had a staff of approximately 2,650 people, including approximately 1,350 mortgage loan officers, as of December 31, 2018 that produced \$13.7 billion in closed mortgage loan volume during 2018, 86% of which related to home purchases volume. PrimeLending offers a variety of loan products catering to the specific needs of borrowers seeking purchase or refinancing options, including 30-year and 15-year fixed rate conventional mortgages, adjustable rate mortgages, jumbo loans, and Federal Housing Administration ("FHA"), Veterans Affairs ("VA"), and United States Department of Agriculture ("USDA") loans. Mortgage loans originated by PrimeLending are secured by a first lien on the underlying property. PrimeLending does not currently originate subprime loans (which it defines to be conventional and government loans that (i) are ineligible for sale to the Federal National Mortgage Association ("FNMA"), Federal Home Loan Mortgage Corporation ("FHLMC") or Government National Mortgage Association ("GNMA"), or (ii) do not comply with approved investor-specific underwriting guidelines).

## Insurance

The operations of NLC comprise our insurance segment. NLC specializes in providing fire and limited homeowners insurance for low value dwellings and manufactured homes primarily in Texas and other areas of the southern, southeastern and southwestern United States through its subsidiaries, NLIC and ASIC. NLC's product lines also include enhanced homeowners products offering higher coverage limits with distribution restricted to select agents. NLC targets underserved markets through a broad network of independent agents primarily located in Texas, Arizona, Tennessee, Oklahoma and Georgia.

Ratings. Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. The financial strength ratings for NLIC and ASIC of “A” (Excellent) were affirmed by A.M. Best in June 2018. An “A” rating is the third highest of 16 rating categories used by A.M. Best. This rating assignment is subject to the ability to meet A.M. Best’s expectations as to performance and capitalization on an ongoing basis, and is subject to revocation or revision at any time at the sole discretion of A.M. Best. NLC cannot ensure that NLIC and ASIC will maintain their present ratings.

Product Lines. NLC’s business is focused on personal lines, specializing in low value dwellings and manufactured housing. Personal lines offered include homeowners, dwelling fire, manufactured home and flood policies.

NLC specializes in writing fire and homeowners insurance coverage for low value dwellings and manufactured homes. The vast majority of NLC’s property coverage is written on policies that provide actual cash value payments, as opposed to replacement cost. Under actual cash value policies, the insured is entitled to receive only the cost of replacing or repairing damaged or destroyed property with comparable new property, less depreciation. Replacement cost coverage does not include such a deduction for depreciation; however, it does include limited water coverage.

## Table of Contents

**Underwriting and Pricing.** NLC applies its regional expertise, underwriting discipline and a risk-adjusted, return-on-equity-based approach to capital allocation to primarily offer short-tail insurance products in its target markets. NLC's underwriting process involves securing an adequate level of underwriting information from its independent agents, identifying and evaluating risk exposures and then pricing the risks it chooses to accept. Management reviews pricing on an ongoing basis to monitor any emerging issues on a specific coverage or geographic territory.

**Catastrophe Exposure.** NLC maintains a comprehensive risk management strategy, which includes actively monitoring its catastrophe-prone territories by zip code to ensure a diversified book of risks. NLC utilizes software and risk support from its reinsurance brokers to analyze its portfolio and catastrophe exposure. Biannually, NLC has its entire portfolio analyzed by its reinsurance broker who utilizes hurricane and severe storm models to predict risk.

**Reinsurance.** NLC purchases reinsurance to reduce its exposure to liability on individual risks and claims and to protect against catastrophe losses. NLC's management believes that less volatile, yet reasonable returns are in the long-term interest of NLC.

Reinsurance involves an insurance company transferring, or ceding, a portion of its risk to another insurer, the reinsurer. The reinsurer assumes the exposure in return for a portion of the premium. The ceding of risk to a reinsurer does not legally discharge the primary insurer from its liability for the full amount of the policies on which it obtains reinsurance.

Accordingly, the primary insurer remains liable for the entire loss if the reinsurer fails to meet its obligations under the reinsurance agreement and, as a result, the primary insurer is exposed to the risk of non-payment by its reinsurers. In formulating its reinsurance programs, NLC believes that it is selective in its choice of reinsurers and considers numerous factors, the most important of which are the financial stability of the reinsurer, its history of responding to claims and its overall reputation.

Additionally, NLC further reduces its exposure to liability through an underlying excess of loss contract that provides aggregate coverage in excess of NLC's per event retention and aggregate retention for sub-catastrophic events.

## Competition

We face significant competition in the business segments in which we operate and the geographic markets we serve. Many of our competitors have substantially greater financial resources, lending limits and branch networks than we do, and offer a broader range of products and services.

Our banking segment primarily competes with national, regional and community banks within the various markets where the Bank operates. The Bank also faces competition from many other types of financial institutions, including savings and loan associations, credit unions, finance companies, pension trusts, mutual funds, insurance companies, brokerage and investment banking firms, asset-based non-bank lenders, government agencies and certain other non-financial institutions. The ability to attract and retain skilled lending professionals is critical to our banking business. Competition for deposits and in providing lending products and services to consumers and businesses in our market area is intense and pricing is important. Other factors encountered in competing for deposits are convenient office locations, interest rates and fee structures of products offered. Direct competition for deposits also comes from other commercial bank and thrift institutions, money market mutual funds and corporate and government securities that may offer more attractive rates than insured depository institutions are willing to pay. Competition for loans is based on factors such as interest rates, loan origination fees and the range of services offered by the provider. We seek to distinguish ourselves from our competitors through our commitment to personalized customer service and responsiveness to customer needs while providing a range of competitive loan and deposit products and other services.

Within our broker-dealer segment, we face significant competition based on a number of factors, including price, perceived expertise, quality of advice, reputation, range of services and products, technology, innovation and local presence. Competition for successful securities traders, stock loan professionals and investment bankers among securities firms and other competitors is intense. Our broker-dealer business competes directly with numerous other financial advisory and investment banking firms, broker-dealers and banks, including large national and major regional firms and smaller niche companies, some of whom are not broker-dealers and, therefore, are not subject to the broker-dealer regulatory framework. Further, our broker-dealer segment competes with discount brokerage firms that do not offer equivalent services but offer discounted prices. We seek to distinguish ourselves from our competitors through our commitment to personalized customer service and responsiveness to customer needs while providing a range of investment banking, advisory and other related financial brokerage services.

## Table of Contents

Our competitors in the mortgage origination business include large financial institutions as well as independent mortgage banking companies, commercial banks, savings banks and savings and loan associations. Our mortgage origination segment competes on a number of factors including customer service, quality and range of products and services offered, price, reputation, interest rates, closing process and duration, and loan origination fees. The ability to attract and retain skilled mortgage origination professionals is critical to our mortgage origination business. We seek to distinguish ourselves from our competitors through our commitment to personalized customer service and responsiveness to customer needs while providing a range of competitive mortgage loan products and services.

Our insurance business competes with a large number of other companies in its selected lines of business, including major U.S. and non-U.S. insurers, regional companies, mutual companies, specialty insurance companies, underwriting agencies and diversified financial services companies. The personal lines market in Texas is dominated by a few large carriers and their subsidiaries and affiliates. We seek to distinguish ourselves from our competitors by targeting underserved market segments that provide us with the best opportunity to obtain favorable policy terms, conditions and pricing.

Overall, competition among providers of financial products and services continues to increase as technological advances have lowered the barriers to entry for financial technology companies, with consumers having the opportunity to select from a growing variety of traditional and nontraditional alternatives, including online checking, savings and brokerage accounts, online lending, online insurance underwriters, crowdfunding, digital wallets, and money transfer services. The ability of non-banking financial institutions to provide services previously limited to commercial banks has intensified competition. Because non-banking financial institutions are not subject to many of the same regulatory restrictions as banks and bank holding companies, they can often operate with greater flexibility and lower cost structures.

## Employees

At December 31, 2018, we employed approximately 5,200 people, substantially all of which are full-time. None of our employees are represented by any collective bargaining unit or a party to any collective bargaining agreement.

## Government Supervision and Regulation

## General



We are subject to extensive regulation under federal and state laws. The regulatory framework is intended primarily for the protection of customers and clients, and not for the protection of our stockholders or creditors. In many cases, the applicable regulatory authorities have broad enforcement power over bank holding companies, banks and their subsidiaries, including the power to impose substantial fines and other penalties for violations of laws and regulations. The following discussion describes the material elements of the regulatory framework that applies to us and our subsidiaries. References in this Annual Report to applicable statutes and regulations are brief summaries thereof, do not purport to be complete, and are qualified in their entirety by reference to such statutes and regulations.

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which significantly altered the regulation of financial institutions and the financial services industry. The Dodd-Frank Act established the Consumer Financial Protection Bureau (“CFPB”) and requires the CFPB and other federal agencies to implement many provisions of the Dodd-Frank Act. Several aspects of the Dodd-Frank Act have affected our business, including, without limitation, increased capital requirements, increased mortgage regulation, restrictions on proprietary trading in securities, restrictions on investments in hedge funds and private equity funds (the “Volcker Rule”), executive compensation restrictions, potential federal oversight of the insurance industry and disclosure and reporting requirements.

Recent Regulatory Developments. New regulations and statutes are regularly proposed and/or adopted that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of financial institutions operating and doing business in the United States. Changes in leadership at various federal banking agencies, including the Federal Reserve, can also change the policy direction of these agencies. Certain of these recent proposals and changes are described below.

On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief and Consumer Protection Act (“EGRRCPA”), which included amendments to the Dodd-Frank Act and other statutes that provide the federal banking agencies with the ability to tailor various provisions of the banking laws and eased the regulatory burden imposed

Table of Contents

by the Dodd-Frank Act with respect to company-run stress testing, resolutions plans, Volcker Rule, high volatility commercial real estate exposures, and real estate appraisals.

In July 2017, the Financial Conduct Authority (“FCA”) announced that it intends to cease compelling banks to submit rates for the calculation of the London Interbank Offered Rate (“LIBOR”) after 2021. The Alternative Reference Rates Committee (“ARRC”) has proposed that the Secured Overnight Financing Rate (“SOFR”) is the rate that represents best practice as the alternative to LIBOR for use in derivatives and other financial contracts that are currently indexed to LIBOR. ARRC has proposed a paced market transition plan to SOFR from LIBOR, and organizations are currently working on industry-wide and company-specific transition plans as it relates to derivatives and cash markets exposed to LIBOR.

We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

Corporate

Hilltop is a legal entity separate and distinct from PCC and its other subsidiaries. On November 30, 2012, concurrent with the consummation of the acquisition of PlainsCapital Corporation (the “PlainsCapital Merger”), Hilltop became a financial holding company registered under the Bank Holding Company Act, as amended by the Gramm-Leach-Bliley Act (“Gramm-Leach-Bliley Act”). Accordingly, it is subject to supervision, regulation and examination by the Federal Reserve Board. The Dodd-Frank Act, Gramm-Leach-Bliley Act, the Bank Holding Company Act and other federal laws subject financial and bank holding companies to particular restrictions on the types of activities in which they may engage and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

Changes of Control. Federal and state laws impose additional notice, approval and ongoing regulatory requirements on any investor that seeks to acquire direct or indirect “control” of a regulated holding company, such as Hilltop. These laws include the Bank Holding Company Act, the Change in Bank Control Act and the Texas Insurance Code. Among other things, these laws require regulatory filings by an investor that seeks to acquire direct or indirect “control” of a regulated holding company. The determination whether an investor “controls” a regulated holding company is based on all of the facts and circumstances surrounding the investment. As a general matter, an investor is deemed to control a depository institution or other company if the investor owns or controls 25% or more of any class of voting stock. Subject to rebuttal, an investor may be presumed to control the regulated holding company if the investor owns or controls 10% or more of any class of voting stock. Accordingly, these laws would apply to a person acquiring 10% or more of Hilltop’s common stock. Furthermore, these laws may discourage potential acquisition proposals and may delay, deter or prevent change of control transactions, including those that some or all of our stockholders might consider to be desirable.

Regulatory Restrictions on Dividends; Source of Strength. It is the policy of the Federal Reserve Board that bank holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company's ability to serve as a source of strength to its banking subsidiaries. The Dodd-Frank Act requires the regulatory agencies to issue regulations requiring that all bank and savings and loan holding companies serve as a source of financial and managerial strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress; however, no such proposed regulations have yet been published.

Under Federal Reserve Board policy, a bank holding company is expected to act as a source of financial strength to each of its banking subsidiaries and commit resources to their support. Such support may be required at times when, absent this Federal Reserve Board policy, a holding company may not be inclined to provide it. As discussed herein, a bank holding company, in certain circumstances, could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

Scope of Permissible Activities. Under the Bank Holding Company Act, Hilltop and PCC generally may not acquire a direct or indirect interest in, or control of more than 5% of, the voting shares of any company that is not a bank or bank holding company. Additionally, the Bank Holding Company Act may prohibit Hilltop from engaging in activities other than those of banking, managing or controlling banks or furnishing services to, or performing services for, its subsidiaries, except that it may engage in, directly or indirectly, certain activities that the Federal Reserve Board has determined to be

## Table of Contents

closely related to banking or managing and controlling banks as to be a proper incident thereto. In approving acquisitions or the addition of activities, the Federal Reserve Board considers, among other things, whether the acquisition or the additional activities can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh such possible adverse effects as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.

Notwithstanding the foregoing, the Gramm-Leach-Bliley Act, effective March 11, 2000, eliminated the barriers to affiliations among banks, securities firms, insurance companies and other financial service providers and permits bank holding companies to become financial holding companies and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. The Gramm-Leach-Bliley Act defines “financial in nature” to include: securities underwriting; dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; and activities that the Federal Reserve Board has determined to be closely related to banking. Prior to enactment of the Dodd-Frank Act, regulatory approval was not required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that were financial in nature or incidental to activities that were financial in nature, as determined by the Federal Reserve Board.

Under the Gramm-Leach-Bliley Act, a bank holding company may become a financial holding company by filing a declaration with the Federal Reserve Board if each of its subsidiary banks is “well capitalized” under the Federal Deposit Insurance Corporation Improvement Act prompt corrective action provisions, is “well managed”, and has at least a “satisfactory” rating under the Community Reinvestment Act of 1977 (the “CRA”). The Dodd-Frank Act underscores the criteria for becoming a financial holding company by amending the Bank Holding Company Act to require that bank holding companies be “well capitalized” and “well managed” in order to become financial holding companies. Hilltop became a financial holding company on December 1, 2012.

**Safe and Sound Banking Practices.** Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The Federal Reserve Board’s Regulation Y, for example, generally requires a holding company to give the Federal Reserve Board prior notice of any redemption or repurchase of its equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company’s consolidated net worth. In addition, bank holding companies are required to consult with the Federal Reserve Board prior to making any redemption or repurchase, even within the foregoing parameters. The Federal Reserve Board may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the Federal Reserve Board could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The Federal Reserve Board has broad authority to prohibit activities of bank holding companies and their nonbanking subsidiaries that represent unsafe and unsound banking practices or that constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing or reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as \$2.01 million for each day the activity continues. In addition, the Dodd-Frank Act authorizes the Federal Reserve Board to require reports from and

examine bank holding companies and their subsidiaries, and to regulate functionally regulated subsidiaries of bank holding companies.

Anti-tying Restrictions. Subject to various exceptions, bank holding companies and their affiliates are generally prohibited from tying the provision of certain services, such as extensions of credit, to certain other services offered by a bank holding company or its affiliates.

Capital Adequacy Requirements and BASEL III. Hilltop and PlainsCapital, which includes the Bank and PrimeLending, are subject to capital adequacy requirements under the comprehensive capital framework for U.S. banking organizations known as “Basel III”. Basel III, which reformed the existing frameworks under which U.S. banking organizations historically operated, became effective January 1, 2015 and is fully phased in as of January 1, 2019. Basel III was developed by the Basel Committee on Banking Supervision and adopted by the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency.

The federal banking agencies’ risk-based capital and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum

## Table of Contents

ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. Federal Reserve Board guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Final rules published by the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency implemented the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Among other things, Basel III increased minimum capital requirements, introduced a new minimum leverage ratio and implemented a capital conservation buffer. The regulatory agencies carefully considered the potential impacts on all banking organizations, including community and regional banking organizations such as Hilltop and PlainsCapital, and sought to minimize the potential burden of these changes where consistent with applicable law and the agencies' goals of establishing a robust and comprehensive capital framework. Under the guidelines in effect beginning January 1, 2015, a risk weight factor of 0% to 1250% is assigned to each category of assets based generally on the perceived credit risk of the asset class. The risk weights are then multiplied by the corresponding asset balances to determine a "risk-weighted" asset base.

Under Basel III, total capital consists of two tiers of capital, Tier 1 and Tier 2. Tier 1 capital consists of common equity Tier 1 capital and additional Tier 1 capital. Below is a list of certain significant components that comprise the tiers of capital for Hilltop and PlainsCapital under Basel III.

### Common equity Tier 1 capital:

- includes common stockholders' equity (such as qualifying common stock and any related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits and foreign currency translation adjustments, excluding changes in other comprehensive income (loss) and treasury stock);
- includes certain minority interests in the equity capital accounts of consolidated subsidiaries; and
- excludes goodwill and various intangible assets.

### Additional Tier 1 capital:

- includes certain qualifying minority interests not included in common equity Tier 1 capital;
- includes certain preferred stock and related surplus;
- includes certain subordinated debt; and
- excludes 50% of the insurance underwriting deduction.

### Tier 2 capital:

- includes allowance for loan losses, up to a maximum of 1.25% of risk-weighted assets;
- includes minority interests not included in Tier 1 capital; and
- excludes 50% of the insurance underwriting deduction.

Hilltop and PlainsCapital began transitioning to the Basel III final rules on January 1, 2015. The capital conservation buffer and certain deductions from common equity Tier 1 capital are fully phased in as of January 1, 2019.

The following table summarizes the Basel III phase-in schedule for periods beginning January 1, 2018.

Year (as of January 1)	2018		2019	
Minimum common equity Tier 1 capital ratio	4.5	%	4.5	%
Common equity Tier 1 capital conservation buffer	1.875	%	2.5	%
Minimum common equity Tier 1 capital ratio plus capital conservation buffer	6.375	%	7.0	%
Minimum Tier 1 capital ratio	6.0	%	6.0	%
Minimum Tier 1 capital ratio plus capital conservation buffer	7.875	%	8.5	%
Minimum total capital ratio	8.0	%	8.0	%
Minimum total capital ratio plus capital conservation buffer	9.875	%	10.5	%
Phase-in of certain capital deductions (1)	100.0	%	100.0	%

Table of Contents

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(1) In November 2017, the regulatory agencies finalized a rule that extends the phase-in schedule for certain capital deductions, including 10% and 15% common equity Tier 1 threshold deduction items that are over the limits, minority interest and significant and non-significant investments in the capital of unconsolidated financial institutions. Other capital deductions, such as intangible assets and deferred tax assets arising from net operating losses, are subject to the original phase-in schedule. The rule became effective on January 1, 2018.

In order to avoid limitations on capital distributions, including dividend payments, stock repurchases and certain discretionary bonus payments to executive officers, Basel III also implemented a capital conservation buffer, which requires a banking organization to hold a buffer above its minimum risk-based capital requirements. This buffer helps to ensure that banking organizations conserve capital when it is most needed, allowing them to better weather periods of economic stress. The buffer is measured relative to risk-weighted assets.

The rules also prohibit a banking organization from making distributions or discretionary bonus payments during any quarter if its eligible retained income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% at the beginning of the quarter. A banking organization with a buffer greater than 2.5% would not be subject to limits on capital distributions or discretionary bonus payments; however, a banking organization with a buffer of less than 2.5% would be subject to increasingly stringent limitations as the buffer approaches zero. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization's quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income. When the rules are fully phased-in in 2019, the minimum capital requirements plus the capital conservation buffer will exceed the prompt corrective action well-capitalized thresholds. During 2018, our eligible retained income was positive and our capital conservation buffer was greater than 2.5%, and therefore, we were not subject to limits on capital distributions or discretionary bonus payments. We anticipate similar results during 2019.

At December 31, 2018, Hilltop had a total capital to risk-weighted assets ratio of 17.47%, Tier 1 capital to risk-weighted assets ratio of 17.04% and a common equity Tier 1 capital to risk-weighted assets ratio of 16.58%. Hilltop's actual capital amounts and ratios in accordance with Basel III exceeded the regulatory capital requirements including conservation buffer in effect at the end of the period and on a fully phased-in basis as if such requirements were currently in effect.

At December 31, 2018, PlainsCapital had a total capital to risk-weighted assets ratio of 14.63%, Tier 1 capital to risk-weighted assets ratio of 13.90% and a common equity Tier 1 capital to risk-weighted assets ratio of 13.90%. Accordingly, PlainsCapital's actual capital amounts and ratios in accordance with Basel III resulted in it being considered "well-capitalized" and exceeded the regulatory capital requirements including conservation buffer in effect at the end of the period and on a fully phased-in basis as if such requirements were currently in effect.

Phase-in of Current Expected Credit Losses Accounting Standard. In June 2016, the Financial Accounting Standards Board issued an update to the accounting standards for credit losses that included the Current Expected Credit Losses ("CECL") methodology, which replaces the existing incurred loss methodology for certain financial assets. CECL



becomes effective January 1, 2020. In December 2018, the federal bank regulatory agencies approved a final rule modifying their regulatory capital rules and providing an option to phase-in, over a period of three years, the day-one regulatory capital effects resulting from the implementation of CECL. The final rule also revises the agencies' other rules to reflect the update to the accounting standards.

**Volcker Rule.** Provisions of the Volcker Rule and the final rules implementing the Volcker Rule restrict certain activities provided by the Company, including proprietary trading and sponsoring or investing in "covered funds," which include many venture capital, private equity and hedge funds. For purposes of the Volcker Rule, purchases or sales of financial instruments such as securities, derivatives, contracts of sale of commodities for future delivery or options on the foregoing for the purpose of short-term gain are deemed to be proprietary trading (with financial instruments held for less than 60 days presumed to be for proprietary trading unless an alternative purpose can be demonstrated), unless certain exemptions apply. Exempted activities include, among others, the following: (i) underwriting; (ii) market making; (iii) risk mitigating hedging; (iv) trading in certain government securities; (v) employee compensation plans and (vi) transactions entered into on behalf of and for the account of clients as agent, broker, custodian, or in a trustee or fiduciary capacity. On December 21, 2018, the federal banking agencies invited public comment on a proposal to implement provisions of EGRRCPA that would exclude community banks with \$10.0 billion or less in total consolidated assets and total trading assets and liabilities of 5% or less of total consolidated assets from the restrictions of the Volcker Rule. At this time the, we do not anticipate that the Bank would qualify for this proposed exclusion. While management continues to assess compliance with the Volcker Rule, we have reviewed our processes and procedures in regard to proprietary trading and covered funds activities and we believe we are currently complying with the provisions of the

## Table of Contents

Volcker Rule. However, it remains uncertain how the scope of applicable restrictions and exceptions will be interpreted and administered by the relevant regulators. Absent further regulatory guidance, we are required to make certain assumptions as to the degree to which our activities, processes and procedures in these areas comply with the requirements of the Volcker Rule. If these assumptions are not accurate or if our implementation of compliance processes and procedures is not consistent with regulatory expectations, we may be required to make certain changes to our business activities, processes or procedures, which could further increase our compliance and regulatory risks and costs.

Acquisitions by Bank Holding Companies. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the Federal Reserve Board before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the Federal Reserve Board is required to consider, among other things, the financial and managerial resources and future prospects of the bank holding company and the banks concerned, the convenience and needs of the communities to be served, and various competitive factors. In addition, the Dodd-Frank Act requires the Federal Reserve Board to consider “the risk to the stability of the U.S. banking or financial system” when evaluating acquisitions of banks and nonbanks under the Bank Holding Company Act. With respect to interstate acquisitions, the Dodd-Frank Act amends the Bank Holding Company Act by raising the standard by which interstate bank acquisitions are permitted from a standard that the acquiring bank holding company be “adequately capitalized” and “adequately managed”, to the higher standard of being “well capitalized” and “well managed”.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring “control” of a bank holding company unless the Federal Reserve Board has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, would, under the circumstances set forth in the presumption, constitute acquisition of control of such company.

## Banking

The Bank is subject to various requirements and restrictions under the laws of the United States, and to regulation, supervision and regular examination by the Texas Department of Banking. The Bank, as a state member bank, is also subject to regulation and examination by the Federal Reserve Board. As a bank with less than \$10 billion in assets, the Bank became subject to the regulations issued by the CFPB on July 21, 2011, although the Federal Reserve Board continued to examine the Bank for compliance with federal consumer protection laws. As of September 30, 2018 and December 31, 2018, the Bank’s total assets were \$9.9 billion and \$10.0 billion, respectively. If the Bank’s total assets are over \$10.0 billion (as measured on four consecutive quarterly call reports of the Bank and any institutions it acquires), the Bank will become subject to the CFPB’s supervisory and enforcement authority with respect to federal consumer financial laws beginning in the following quarter.

The Bank is also an insured depository institution and, therefore, subject to regulation by the FDIC, although the Federal Reserve Board is the Bank's primary federal regulator. The Federal Reserve Board, the Texas Department of Banking, the CFPB and the FDIC have the power to enforce compliance with applicable banking statutes and regulations. Such requirements and restrictions include requirements to maintain reserves against deposits, restrictions on the nature and amount of loans that may be made and the interest that may be charged thereon and restrictions relating to investments and other activities of the Bank. In July 2010, the FDIC voted to revise its agreement with the primary federal regulators to enhance the FDIC's existing backup authorities over insured depository institutions that the FDIC does not directly supervise. As a result, the Bank may be subject to increased supervision by the FDIC.

Restrictions on Transactions with Affiliates. Transactions between the Bank and its nonbanking affiliates, including Hilltop and PCC, are subject to Section 23A of the Federal Reserve Act. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties that are collateralized by the securities or obligations of Hilltop or its subsidiaries. Among other changes, the Dodd-Frank Act expands the definition of "covered transactions" and clarifies the amount of time that the collateral requirements must be satisfied for covered transactions, and amends the definition of "affiliate" in Section 23A to include "any investment fund with respect to which a member bank or an affiliate thereof is an investment adviser."

## Table of Contents

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act, which generally requires that certain transactions between the Bank and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons. The Federal Reserve has also issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretive guidance with respect to affiliate transactions.

**Loans to Insiders.** The restrictions on loans to directors, executive officers, principal stockholders and their related interests (collectively referred to herein as “insiders”) contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include conditions that must be met before insider loans can be made, limits on loans to an individual insider and an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution’s total unimpaired capital and surplus, and the Federal Reserve Board may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions. The Dodd-Frank Act amends the statutes placing limitations on loans to insiders by including credit exposures to the person arising from a derivatives transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between the member bank and the person within the definition of an extension of credit.

**Restrictions on Distribution of Subsidiary Bank Dividends and Assets.** Dividends paid by the Bank have provided a substantial part of PCC’s operating funds and for the foreseeable future it is anticipated that dividends paid by the Bank to PCC will continue to be PCC’s and Hilltop’s principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the Bank. Pursuant to the Texas Finance Code, a Texas banking association may not pay a dividend that would reduce its outstanding capital and surplus unless it obtains the prior approval of the Texas Banking Commissioner. Additionally, the FDIC and the Federal Reserve Board have the authority to prohibit Texas state banks from paying a dividend when they determine the dividend would be an unsafe or unsound banking practice. As a member of the Federal Reserve System, the Bank must also comply with the dividend restrictions with which a national bank would be required to comply. Those provisions are generally similar to those imposed by the state of Texas. Among other things, the federal restrictions require that if losses have at any time been sustained by a bank equal to or exceeding its undivided profits then on hand, no dividend may be paid.

In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its stockholders, including any depository institution holding company (such as PCC and Hilltop) or any stockholder or creditor thereof.

**Branching.** The establishment of a bank branch must be approved by the Texas Department of Banking and the Federal Reserve Board, which consider a number of factors, including financial history, capital adequacy, earnings prospects, character of management, needs of the community and consistency with corporate powers. The regulators will also consider the applicant’s CRA record. Under the Dodd-Frank Act, de novo interstate branching by banks is permitted if, under the laws of the state where the branch is to be located, a state bank chartered in that state would be permitted to establish a branch.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) establishes a system of prompt corrective action to resolve the problems of undercapitalized financial institutions. Under this system, the federal banking regulators have established five capital categories (“well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” and “critically undercapitalized”) in which all institutions are placed. Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to institutions in the three undercapitalized categories. The severity of the action depends upon the capital category in which the institution is placed. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category.

An institution that is categorized as “undercapitalized”, “significantly undercapitalized” or “critically undercapitalized” is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. A bank holding company must guarantee that a subsidiary depository institution meets its capital restoration plan, subject to various limitations. The controlling holding company’s obligation to fund a capital restoration plan is limited to the lesser of 5% of an undercapitalized subsidiary’s assets at the time it became undercapitalized or the amount required to meet regulatory capital requirements. An undercapitalized institution is also generally prohibited from increasing its average total assets,

## Table of Contents

making acquisitions, establishing any branches or engaging in any new line of business, except under an accepted capital restoration plan or with FDIC approval. The regulations also establish procedures for downgrading an institution to a lower capital category based on supervisory factors other than capital. PlainsCapital was classified as “well capitalized” at December 31, 2018.

Pursuant to FDICIA, an “undercapitalized” bank is prohibited from increasing its assets, engaging in a new line of business, acquiring any interest in any company or insured depository institution, or opening or acquiring a new branch office, except under certain circumstances, including the acceptance by the federal banking regulators of a capital restoration plan for the bank.

**FDIC Insurance Assessments.** The FDIC has adopted a risk-based assessment system for insured depository institutions that takes into account the risks attributable to different categories and concentrations of assets and liabilities. The system assigns an institution to one of three capital categories: (1) “well capitalized;” (2) “adequately capitalized;” or (3) “undercapitalized.” These three categories are substantially similar to the prompt corrective action categories described above, with the “undercapitalized” category including institutions that are undercapitalized, significantly undercapitalized and critically undercapitalized for prompt corrective action purposes. The FDIC also assigns an institution to one of three supervisory subgroups based on a supervisory evaluation that the institution’s primary federal regulator provides to the FDIC and information that the FDIC determines to be relevant to the institution’s financial condition and the risk posed to the deposit insurance funds. The FDIC may terminate its insurance of deposits if it finds that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

The FDIC is required to maintain a designated reserve ratio of the deposit insurance fund (“DIF”) to insured deposits in the United States. The Dodd-Frank Act requires the FDIC to assess insured depository institutions to achieve a DIF ratio of at least 1.35% by September 30, 2020. On November 28, 2018, the FDIC announced that the DIF reserve ratio exceeded the statutorily required minimum reserve ratio of 1.35%, ahead of the September 30, 2020 deadline. FDIC regulations provide for two changes to deposit insurance assessments upon reaching the minimum ratio: (1) surcharges on insured depository institutions with total consolidated assets of \$10.0 billion or more (large banks) will cease; and (2) small banks will receive assessment credits for the portion of their assessments that contributed to the growth in the reserve ratio from between 1.15% and 1.35%, to be applied when the reserve ratio is at or above 1.38%. Pursuant to its authority in the Dodd-Frank Act, the FDIC on December 20, 2010, published a final rule establishing a higher long-term target DIF ratio of greater than 2%. Deposit insurance assessment rates are subject to change by the FDIC and will be impacted by the overall economy and the stability of the banking industry as a whole. The FDIC will notify the Bank concerning any assessment credits and the assessment rate that we will be charged for the assessment period. As a result of the new regulations, we expect to incur lower annual deposit insurance assessments, which could have a positive impact on our financial condition and results of operations. Accruals for DIF assessments were \$2.5 million during 2018.

The Dodd-Frank Act permanently increased the standard maximum deposit insurance amount to \$250,000. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category.

Community Reinvestment Act. The CRA requires, in connection with examinations of financial institutions, that federal banking regulators (in the Bank's case, the Federal Reserve Board) evaluate the record of each financial institution in meeting the credit needs of its local community, including low and moderate-income neighborhoods. These facts are also considered in evaluating mergers, acquisitions and applications to open a branch or facility. Failure to adequately meet these criteria could impose additional requirements and limitations on the Bank. Additionally, the Bank must publicly disclose the terms of various CRA-related agreements.

The Bank received a "satisfactory" CRA rating in connection with its most recent CRA performance evaluation. A CRA rating of less than "satisfactory" adversely affects a bank's ability to establish new branches and impairs a bank's ability to commence new activities that are "financial in nature" or acquire companies engaged in these activities. See "Risk Factors — We are subject to extensive supervision and regulation that could restrict our activities and impose financial requirements or limitations on the conduct of our business and limit our ability to generate income."

Privacy. Under the Gramm-Leach-Bliley Act, financial institutions are required to disclose their policies for collecting and protecting confidential information. Customers generally may prevent financial institutions from sharing nonpublic personal financial information with nonaffiliated third parties except under narrow circumstances, such as the processing of transactions requested by the consumer or when the financial institution is jointly sponsoring a product or service with

Table of Contents

a nonaffiliated third party. Additionally, financial institutions generally may not disclose consumer account numbers to any nonaffiliated third party for use in telemarketing, direct mail marketing or other marketing to consumers. The Bank and all of its subsidiaries have established policies and procedures to comply with the privacy provisions of the Gramm-Leach-Bliley Act.

**Federal Laws Applicable to Credit Transactions.** The loan operations of the Bank are also subject to federal laws and implementing regulations applicable to credit transactions, such as the Truth-In-Lending Act, the Home Mortgage Disclosure Act of 1975, the Equal Credit Opportunity Act, the Fair Credit Reporting Act of 1978, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act, the Dodd-Frank Act and rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws. Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates.

**Federal Laws Applicable to Deposit Operations.** The deposit operations of the Bank are subject to the Right to Financial Privacy Act, the Truth in Savings Act and the Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve Board and the CFPB to implement that act. The Dodd-Frank Act amends the Electronic Funds Transfer Act to, among other things, give the Federal Reserve Board the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.

**Capital Requirements.** The Federal Reserve Board and the Texas Department of Banking monitor the capital adequacy of PlainsCapital by using a combination of risk-based guidelines and leverage ratios. The agencies consider PlainsCapital's capital levels when taking action on various types of applications and when conducting supervisory activities related to the safety and soundness of individual banks and the banking system.

Under the regulatory capital guidelines within the Basel III capital rules, PlainsCapital must maintain a total risk-based capital to risk-weighted assets ratio of at least 8.0%, a Tier 1 capital to risk-weighted assets ratio of at least 6.0%, a common equity Tier 1 capital to risk-weighted assets ratio of at least 4.5%, and a Tier 1 capital to average total assets ratio of at least 4.0% (3.0% for banks receiving the highest examination rating) to be considered "adequately capitalized." See the discussion herein under "The FDIC Improvement Act." At December 31, 2018, PlainsCapital's ratio of total risk-based capital to risk-weighted assets was 14.63%, PlainsCapital's ratio of Tier 1 capital to risk-weighted assets was 13.90%, PlainsCapital's common equity Tier 1 capital to risk-weighted assets ratio was 13.90%, and PlainsCapital's ratio of Tier 1 capital to average total assets was 12.47%.

On January 1, 2015, PlainsCapital began transitioning to the final rules that substantially amend the regulatory risk-based capital rules to implement the Basel III regulatory capital reforms. For additional discussion of Basel III, see the section entitled "Government Supervision and Regulation — Corporate — Capital Adequacy Requirements and Basel III" earlier in this Item 1.



The FDIC Improvement Act. FDICIA made a number of reforms addressing the safety and soundness of the deposit insurance system, supervision of domestic and foreign depository institutions, and improvement of accounting standards. This statute also limited deposit insurance coverage, implemented changes in consumer protection laws and provided for least-cost resolution and prompt regulatory action with regard to troubled institutions.

FDICIA requires every bank with total assets in excess of \$500 million to have an annual independent audit made of the bank's financial statements by a certified public accountant to verify that the financial statements of the bank are presented in accordance with GAAP and comply with such other disclosure requirements as prescribed by the FDIC.

Brokered Deposits. Under FDICIA, banks may be restricted in their ability to accept brokered deposits, depending on their capital classification. "Well capitalized" banks are permitted to accept brokered deposits, but banks that are not "well capitalized" are not permitted to accept such deposits. The FDIC may, on a case-by-case basis, permit banks that are "adequately capitalized" to accept brokered deposits if the FDIC determines that acceptance of such deposits would not constitute an unsafe or unsound banking practice with respect to the bank. Pursuant to a provision in EGRRCPA, the FDIC proposed exempting certain reciprocal deposits from being considered as brokered deposits for certain insured depository institutions. The FDIC also plans to seek comments on the FDIC's overall brokered deposit regulations. At December 31, 2018, PlainsCapital was "well capitalized" and therefore not subject to any limitations with respect to its brokered deposits.

## Table of Contents

Check Clearing for the 21st Century Act. The Check Clearing for the 21st Century Act gives “substitute checks,” such as a digital image of a check and copies made from that image, the same legal standing as the original paper check.

Federal Home Loan Bank System. The Federal Home Loan Bank (“FHLB”) system, of which the Bank is a member, consists of regional FHLBs governed and regulated by the Federal Housing Finance Board. The FHLBs serve as reserve or credit facilities for member institutions within their assigned regions. The reserves are funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB system. The FHLBs make loans (i.e., advances) to members in accordance with policies and procedures established by the FHLB and the boards of directors of each regional FHLB.

As a system member, according to currently existing policies and procedures, the Bank is entitled to borrow from the FHLB of its respective region and is required to own a certain amount of capital stock in the FHLB. The Bank is in compliance with the stock ownership rules with respect to such advances, commitments and letters of credit and home mortgage loans and similar obligations. All loans, advances and other extensions of credit made by the FHLB to the Bank are secured by a portion of the respective mortgage loan portfolio, certain other investments and the capital stock of the FHLB held by the Bank.

Fixing America’s Surface Transportation Act (FAST Act). The FAST Act, signed by President Obama on December 4, 2015, provides for funding highways and infrastructure in the United States. Part of the funding for this law comes from a reduction of the dividends paid by the Federal Reserve to its stockholders with total consolidated assets of more than \$10 billion, effective January 1, 2016. On that date, the annual dividend on paid-in capital stock for stockholders with total consolidated assets of more than \$10 billion shall be the lesser of: (i) the rate equal to the high yield of the 10-year Treasury note auctioned at the last auction held prior to the payment of such dividend and (ii) 6 percent. The Federal Reserve Board published a final rule implementing these requirements on November 23, 2016. On November 13, 2017, the Federal Reserve published its annual adjustment to the consolidated asset threshold, increasing it to \$10.283 billion through December 31, 2018. As of December 31, 2018, the Bank’s total assets were \$10.0 billion.

Anti-terrorism and Money Laundering Legislation. The Bank is subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism of 2001, as amended (the “USA PATRIOT Act”), the Bank Secrecy Act and rules and regulations of the Office of Foreign Assets Control. These statutes and related rules and regulations impose requirements and limitations on specific financial transactions and account relationships intended to guard against money laundering and terrorism financing. The Bank has established a customer identification program pursuant to Section 326 of the USA PATRIOT Act and the Bank Secrecy Act, and otherwise has implemented policies and procedures intended to comply with the foregoing rules.

Incentive Compensation Guidance. On June 21, 2010, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the FDIC jointly issued comprehensive final guidance on incentive compensation policies (the “Incentive Compensation Guidance”) intended to ensure that the incentive compensation

policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The Incentive Compensation Guidance sets expectations for banking organizations concerning their incentive compensation arrangements and related risk-management, control and governance processes. The Incentive Compensation Guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon three primary principles: (i) balanced risk-taking incentives, (ii) compatibility with effective controls and risk management, and (iii) strong corporate governance. Any deficiencies in compensation practices that are identified may be incorporated into the organization's supervisory ratings, which can affect its ability to make acquisitions or perform other actions. In addition, under the Incentive Compensation Guidance, a banking organization's federal regulator may initiate enforcement action if the organization's incentive compensation arrangements pose a risk to the safety and soundness of the organization.

#### Broker-Dealer

The Hilltop Broker-Dealers are broker-dealers registered with the SEC, FINRA, all 50 U.S. states and the District of Columbia. Hilltop Securities is also registered in Puerto Rico and the U.S. Virgin Islands. Much of the regulation of broker-dealers, however, has been delegated to self-regulatory organizations, principally FINRA, the Municipal Securities Rulemaking Board and national securities exchanges. These self-regulatory organizations adopt rules (which are subject to approval by the SEC) for governing its members and the industry. Broker-dealers are also subject to federal securities laws and SEC rules, as well as the laws and rules of the states in which a broker-dealer conducts business. The Hilltop Broker-Dealers are members of, and are primarily subject to regulation, supervision and regular examination by FINRA.

Table of Contents

The regulations to which broker-dealers are subject cover all aspects of the securities business, including, but not limited to, sales and trade practices, net capital requirements, record keeping and reporting procedures, relationships and conflicts with customers, the handling of cash and margin accounts, experience and training requirements for certain employees, the conduct of investment banking and research activities and the conduct of registered persons, directors, officers and employees. Broker-dealers are also subject to the privacy and anti-money laundering laws and regulations discussed herein. Additional legislation, changes in rules promulgated by the SEC, securities exchanges, or self-regulatory organizations or changes in the interpretation or enforcement of existing laws and rules often directly affect the method of operation and profitability of broker-dealers. The SEC, securities exchanges, self-regulatory organizations and states may conduct administrative and enforcement proceedings that can result in censure, fine, suspension or expulsion of broker-dealers, their registered persons, officers or employees. The principal purpose of regulation and discipline of broker-dealers is the protection of customers and the securities markets rather than protection of creditors and stockholders of broker-dealers.

**Limitation on Businesses.** The businesses that the Hilltop Broker-Dealers may conduct are limited by its agreements with, and its oversight by, FINRA, other regulatory authorities and federal and state law. Participation in new business lines, including trading of new products or participation on new exchanges or in new countries often requires governmental and/or exchange approvals, which may take significant time and resources. In addition, the Hilltop Broker-Dealers are operating subsidiaries of Hilltop, which means its activities are further limited by those that are permissible for subsidiaries of financial holding companies, and as a result, may be prevented from entering new businesses that may be profitable in a timely manner, if at all.

**Net Capital Requirements.** The SEC, FINRA and various other regulatory authorities have stringent rules and regulations with respect to the maintenance of specific levels of net capital by regulated entities. Rule 15c3-1 of the Exchange Act (the “Net Capital Rule”) requires that a broker-dealer maintain minimum net capital. Generally, a broker-dealer’s net capital is net worth plus qualified subordinated debt less deductions for non-allowable (or non-liquid) assets and other adjustments and operational charges. At December 31, 2018, the Hilltop Broker-Dealers were in compliance with applicable net capital requirements.

The SEC, CFTC, FINRA and other regulatory organizations impose rules that require notification when net capital falls below certain predefined thresholds. These rules also dictate the ratio of debt-to-equity in the regulatory capital composition of a broker-dealer, and constrain the ability of a broker-dealer to expand its business under certain circumstances. If a broker-dealer fails to maintain the required net capital, it may be subject to penalties and other regulatory sanctions, including suspension or revocation of registration by the SEC or applicable regulatory authorities, and suspension or expulsion by these regulators could ultimately lead to the broker-dealer’s liquidation. Additionally, the Net Capital Rule and certain FINRA rules impose requirements that may have the effect of prohibiting a broker-dealer from distributing or withdrawing capital and requiring prior notice to, and approval from, the SEC and FINRA for certain capital withdrawals.

Compliance with the net capital requirements may limit our operations, requiring the intensive use of capital. Such rules require that a certain percentage of our assets be maintained in relatively liquid form and therefore act to restrict our ability to withdraw capital from our broker-dealer entities, which in turn may limit our ability to pay dividends, repay debt or redeem or purchase shares of our outstanding common stock. Any change in such rules or the imposition of new rules affecting the scope, coverage, calculation or amount of capital requirements, or a significant operating loss or any unusually large charge against capital, could adversely affect our ability to pay dividends, repay debt, meet our debt covenant requirements or to expand or maintain our operations. In addition, such rules may require us to make substantial capital contributions into one or more of the Hilltop Broker-Dealers in order for such subsidiaries to comply with such rules, either in the form of cash or subordinated loans made in accordance with the requirements of all applicable net capital rules.

**Customer Protection Rule.** The Hilltop Broker-Dealers that hold customers' funds and securities are subject to the SEC's customer protection rule (Rule 15c3-3 under the Exchange Act), which generally provides that such broker-dealers maintain physical possession or control of all fully-paid securities and excess margin securities carried for the account of customers and maintain certain reserves of cash or qualified securities.

**Securities Investor Protection Corporation ("SIPC").** The Hilltop Broker-Dealers are subject to the Securities Investor Protection Act and belong to SIPC, whose primary function is to provide financial protection for the customers of failing

## Table of Contents

brokerage firms. SIPC provides protection for customers up to \$500,000, of which a maximum of \$250,000 may be in cash.

**Anti-Money Laundering.** The Hilltop Broker-Dealers must also comply with the USA PATRIOT Act and other rules and regulations, including FINRA requirements, designed to fight international money laundering and to block terrorist access to the U.S. financial system. We are required to have systems and procedures to ensure compliance with such laws and regulations.

**CFTC Oversight.** Hilltop Securities and HTS Independent Network are registered as introducing brokers with the CFTC and NFA. The CFTC also has net capital regulations (CFTC Rule 1.17) that must be satisfied. Our futures business is also regulated by the NFA, a registered futures association. Violation of the rules of the CFTC, the NFA or the commodity exchanges could result in remedial actions including fines, registration restrictions or terminations, trading prohibitions or revocations of commodity exchange memberships.

**Investment Advisory Activity.** Hilltop Securities Asset Management, LLC, Hilltop Securities and HTS Independent Network are registered with, and subject to oversight and inspection by, the SEC as investment advisers under the Investment Advisers Act of 1940, as amended. The investment advisory business of our subsidiaries is subject to significant federal regulation, including with respect to wrap fee programs, the management of client accounts, the safeguarding of client assets, client fees and disclosures, transactions among affiliates and recordkeeping and reporting procedures. Legislation and changes in regulations promulgated by the SEC or changes in the interpretation or enforcement of existing laws and regulations often directly affect the method of operation and profitability of investment advisers. The SEC may conduct administrative and enforcement proceedings that can result in censure, fine, suspension, revocation or expulsion of the investment advisory business of our subsidiaries, our officers or employees.

**Volcker Rule.** Provisions of the Volcker Rule and the final rules implementing the Volcker Rule also restrict certain activities provided by the Hilltop Broker-Dealers, including proprietary trading and sponsoring or investing in “covered funds.”

**Changing Regulatory Environment.** The regulatory environment in which the Hilltop Broker-Dealers operate is subject to frequent change. Our business, financial condition and operating results may be adversely affected as a result of new or revised legislation or regulations imposed by the U.S. Congress, the SEC, FINRA or other U.S. and state governmental and regulatory authorities. The business, financial condition and operating results of the Hilltop Broker-Dealers also may be adversely affected by changes in the interpretation and enforcement of existing laws and rules by these governmental and regulatory authorities. In the current era of heightened regulation of financial institutions, the Hilltop Broker-Dealers can expect to incur increasing compliance costs, along with the industry as a whole.

## Mortgage Origination

PrimeLending and the Bank are subject to the rules and regulations of the CFPB, FHA, VA, FNMA, FHLMC and GNMA with respect to originating, processing, selling and servicing mortgage loans and the issuance and sale of mortgage-backed securities. Those rules and regulations, among other things, prohibit discrimination and establish underwriting guidelines which include provisions for inspections and appraisals, require credit reports on prospective borrowers and fix maximum loan amounts, and, with respect to VA loans, fix maximum interest rates. Mortgage origination activities are subject to, among others, the Equal Credit Opportunity Act, Fair Housing Act, Federal Truth-in-Lending Act, Secure and Fair Enforcement of Mortgage Licensing Act, Home Mortgage Disclosure Act, Fair Credit Reporting Act and the Real Estate Settlement Procedures Act and the regulations promulgated thereunder which, among other things, prohibit discrimination and require the disclosure of certain basic information to borrowers concerning credit terms and settlement costs. PrimeLending and the Bank are also subject to regulation by the Texas Department of Banking with respect to, among other things, the establishment of maximum origination fees on certain types of mortgage loan products. PrimeLending and the Bank are also subject to the provisions of the Dodd-Frank Act. Among other things, the Dodd-Frank Act established the CFPB and provides mortgage reform provisions regarding a customer's ability to repay, restrictions on variable-rate lending, loan officers' compensation, risk retention, and new disclosure requirements. The Dodd-Frank Act also clarifies that applicable state laws, rules and regulations related to the origination, processing, selling and servicing of mortgage loans continue to apply to PrimeLending.

## Table of Contents

The final rules concerning mortgage origination and servicing address the following topics:

**Ability to Repay.** This final rule implements the Dodd-Frank Act provisions requiring that for residential mortgages, creditors must make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms. The final rule also establishes a presumption of compliance with the ability to repay determination for a certain category of mortgages called “qualified mortgages” meeting a series of detailed requirements. The final rule also provides a rebuttable presumption for higher-priced mortgage loans.

**High-Cost Mortgage.** This final rule strengthens consumer protections for high-cost mortgages (generally bans balloon payments and prepayment penalties, subject to exceptions and bans or limits certain fees and practices) and requires consumers to receive information about homeownership counseling prior to taking out a high-cost mortgage.

**Appraisals for High-Risk Mortgages.** The final rule permits a creditor to extend a higher-priced (subprime) mortgage loan (“HPML”) only if the following conditions are met (subject to exceptions): (i) the creditor obtains a written appraisal; (ii) the appraisal is performed by a certified or licensed appraiser; and (iii) the appraiser conducts a physical property visit of the interior of the property. The rule also requires that during the application process, the applicant receives a notice regarding the appraisal process and their right to receive a free copy of the appraisal.

**Copies of Appraisals.** This final rule amends Regulation B that implements the Equal Credit Opportunity Act. It requires a creditor to provide a free copy of appraisal or valuation reports prepared in connection with any closed-end loan secured by a first lien on a dwelling. The final rule requires notice to applicants of the right to receive copies of any appraisal or valuation reports and creditors must send copies of the reports whether or not the loan transaction is consummated. Creditors must provide the copies of the appraisal or evaluation reports for free, however, the creditors may charge reasonable fees for the cost of the appraisal or valuation unless applicable law provides otherwise.

**Escrow Requirements.** This final rule implements Dodd-Frank Act changes that generally extend the required duration of an escrow account on certain higher-priced mortgage loans from a minimum of one year to a minimum of five years, subject to certain exemptions for loans made by certain creditors that operate predominantly in rural or underserved areas, as long as certain other criteria are met. This final rule became effective on June 1, 2013.

**Servicing.** Two final rules were published to implement laws to protect consumers from detrimental actions by mortgage servicers and to provide consumers with better tools and information when dealing with mortgage servicers. One final rule amends Regulation Z, which implements the Truth in Lending Act, and a second final rule amends Regulation X, which implements the Real Estate Settlement Procedures Act. The rules cover nine major topics implementing the Dodd-Frank Act provisions related to mortgage servicing. The final rules include a number of exemptions and other adjustments for small servicers, defined as servicers that service 5,000 or fewer mortgage loans



and service only mortgage loans that they or an affiliate originated or own.

**Mortgage Loan Originator Compensation.** This final rule implements Dodd-Frank Act requirements, as well as revises and clarifies existing regulations and commentary on loan originator compensation. The rule also prohibits, among other things: (i) certain arbitration agreements; (ii) financing certain credit insurance in connection with a mortgage loan; (iii) compensation based on a term of a transaction or a proxy for a term of a transaction; and (iv) dual compensation from a consumer and another person in connection with the transaction. The final rule also imposes a duty on individual loan officers, mortgage brokers and creditors to be “qualified” and, when applicable, registered or licensed to the extent required under applicable State and Federal law.

**Risk Retention.** This final rule implements the requirements of the Dodd-Frank Act that at least one sponsor of each securitization retains at least 5% of the credit risk of the assets collateralizing asset-backed securities. Sponsors are prohibited from hedging or transferring this credit risk, and the rule applies in both public and private transactions. Securitizations backed by “qualified residential mortgages” or “servicing assets” are exempt from the rule, and the definition of “qualified residential mortgages” is subject to review of the joint regulators every five years. The rule became effective on December 24, 2015 with respect to asset-backed securities collateralized by residential mortgages and December 24, 2016 with respect to all other classes of asset-backed securities.

Any additional regulatory requirements affecting our mortgage origination operations will result in increased compliance costs and may impact revenue.

Table of Contents

Insurance

NLC's insurance subsidiaries, NLIC and ASIC, are subject to regulation and supervision in each state where they are licensed to do business. This regulation and supervision is vested in state agencies having broad administrative power over the various aspects of the business of NLIC and ASIC.

State insurance holding company regulation. NLC controls two operating insurance companies, NLIC and ASIC, and is subject to the insurance holding company laws of Texas, the state in which those insurance companies are domiciled. These laws generally require NLC to register with the Texas Department of Insurance ("TDI") and periodically to furnish financial and other information about the operations of companies within its holding company structure. Generally under these laws, all transactions between an insurer and an affiliated company in its holding company structure, including sales, loans, reinsurance agreements and service agreements, must be fair and reasonable and, if satisfying a specified threshold amount or of a specified category, require prior notice and approval or non-objection by the TDI.

National Association of Insurance Commissioners. The National Association of Insurance Commissioners ("NAIC") is a group consisting of state insurance commissioners that discuss issues and formulate policy with respect to regulation, reporting and accounting for insurance companies. Although the NAIC has no legislative authority and insurance companies are at all times subject to the laws of their respective domiciliary states and, to a lesser extent, other states in which they conduct business, the NAIC is influential in determining the form in which such laws are enacted. Certain Model Insurance Laws, Regulations and Guidelines, or Model Laws, have been promulgated by the NAIC as a minimum standard by which state regulatory systems and regulations are measured. Adoption of state laws that provide for substantially similar regulations to those described in the Model Laws is a requirement for accreditation by the NAIC.

The NAIC provides authoritative guidance to insurance regulators on current statutory accounting issues by promulgating and updating a codified set of statutory accounting practices in its Accounting Practices and Procedures Manual. The TDI has generally adopted these codified statutory accounting practices.

Texas also has adopted laws substantially similar to the NAIC's risk based capital ("RBC") laws, which require insurers to maintain minimum levels of capital based on their investments and operations. Domestic property and casualty insurers are required to report their RBC based on a formula that attempts to measure statutory capital and surplus needs based on the risks in the insurer's mix of products and investment portfolio. The formula is designed to allow the TDI to identify potential inadequately capitalized companies. Under the formula, a company determines its RBC by taking into account certain risks related to its assets (including risks related to its investment portfolio and ceded reinsurance) and its liabilities (including underwriting risks related to the nature and experience of its insurance business). Among other requirements, an insurance company must maintain capital and surplus of at least 200% of the

RBC computed by the NAIC's RBC model (known as the "Authorized Control Level" of RBC). At December 31, 2018, NLIC and ASIC capital and surplus levels exceeded the minimum RBC requirements that would trigger regulatory attention. In their 2018 statutory financial statements, both NLIC and ASIC complied with the NAIC's RBC reporting requirements.

The NAIC's Insurance Regulatory Information System ("IRIS") was developed to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies. IRIS identifies twelve industry ratios and specifies a range of "usual values" for each ratio. Departure from the usual values on four or more of these ratios can lead to inquiries from state insurance commissioners as to certain aspects of an insurer's business. For 2018, all ratios for both NLIC and ASIC were within the usual values with three exceptions. Both companies fell below the indicated minimum investment yield range of 2%, with NLIC at 1.6% and ASIC at 0.6%, due to the concentration in cash at each company and reductions in the fair value of equity investments in accordance with a recently adopted accounting standard related to accounting for financial instruments. We expect improvement in the yields at both companies as appropriate investment opportunities are identified. Both NLIC and ASIC also fell below the bottom of the gross change in policyholder surplus and change in adjusted policyholder surplus range of -10%, with NLIC at -16% and ASIC at -21%. This is a result of \$24.5 million of aggregate dividends paid from NLIC and ASIC during 2018. Surplus levels remain within acceptable premium to surplus ranges. ASIC's two-year overall operating ratio of 102% was higher than the indicated ratio of 100% due primarily to decreases in premiums earned and increases in loss and loss adjustment expenses ("LAE") over the past two years.

Federal Office of Insurance. The Dodd-Frank Act established within the Treasury Department a Federal Office of Insurance ("FIO") and vested FIO with the authority to monitor all aspects of the insurance sector, monitor the extent to

Table of Contents

which traditionally underserved communities and consumers have access to affordable non-health insurance products, and to represent the United States on prudential aspects of international insurance matters. Management is monitoring the activities of the FIO for any possible federal regulation of the insurance industry.

Legislative changes. From time to time, various regulatory and legislative changes have been, or are, proposed that would adversely affect the insurance industry. Among the proposals that have been, or are being, considered are the possible introduction of Federal regulation in addition to, or in lieu of, the current system of state regulation of insurers and proposals in various state legislatures (some of which proposals have been enacted) to conform portions of their insurance laws and regulations to various Model Laws adopted by the NAIC. NLC is unable to predict whether any of these laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on its financial condition or results of operations.

The Terrorism Risk Insurance Program Reauthorization Act of 2015 extended a Federal Program designed to ensure the availability of commercial insurance coverage for terrorist acts in the United States through December 31, 2020 and set the reimbursement percentage at 85%, subject to a decrease of one percentage point per calendar year until it equals 80%, and the deductible at 20%. Although NLC is protected by federally funded terrorism reinsurance, there is a substantial deductible that must be met, the payment of which could have an adverse effect on its financial condition and results of operations. NLC's deductible under this Federal Program was \$0.6 million for 2018 and is estimated to be \$0.5 million in 2019. Potential future changes could also adversely affect NLC by causing its reinsurers to increase prices or withdraw from certain markets where terrorism coverage is required. NLC had no terrorism-related losses in 2018.

State insurance regulations. State insurance authorities have broad powers to regulate U.S. insurance companies. The primary purposes of these powers are to promote insurer solvency and to protect individual policyholders. The extent of regulation varies, but generally has its source in statutes that delegate regulatory, supervisory and administrative power to state insurance departments. These powers relate to, among other things, licensing to transact business, accreditation of reinsurers, admittance of assets to statutory surplus, regulating unfair trade and claims practices, establishing actuarial requirements and solvency standards, regulating investments and dividends, and regulating policy forms, related materials and premium rates. State insurance laws and regulations require insurance companies to file financial statements prepared in accordance with accounting principles prescribed by insurance departments in states in which they conduct insurance business, and their operations are subject to examination by those departments.

As part of the broad authority that state insurance commissioners hold, they may impose periodic rules or regulations related to local issues or events. An example is the State of Oklahoma's prohibition on the cancellation of policies for nonpayment of premium in the wake of severe tornadic activity during 2013. Due to the extent of damage and displacement of people, inability of mail to reach policyholders and inaccessibility of entire neighborhoods, the State of Oklahoma prohibited insurance companies from canceling or non-renewing policies for a period of time following the specific event.

Periodic financial and market conduct examinations. The insurance departments in every state in which NLC's insurance companies do business may conduct on-site visits and examinations of its insurance companies at any time to review the insurance companies' financial condition, market conduct and relationships and transactions with affiliates. In addition, the TDI will conduct comprehensive examinations of insurance companies domiciled in Texas every three to five years. Examinations are generally carried out in cooperation with the insurance departments of other licensing states under guidelines promulgated by the NAIC.

In June 2017, the TDI delivered an examination report of NLIC and ASIC through December 31, 2015. This examination report contained no information of any significant compliance issues and there is no indication of any significant changes to our financial statements as a result of the examination by the domiciliary state.

State dividend limitations. The TDI must approve any dividend declared or paid by an insurance company domiciled in the state if the dividend, together with all dividends declared or distributed by that insurance company during the preceding twelve months, exceeds the greater of (1) 10% of its policyholders' surplus as of December 31 of the preceding year or (2) 100% of its net income for the preceding calendar year. The greater number is known as the insurer's extraordinary dividend limit. At December 31, 2018, the extraordinary dividend limit for NLIC and ASIC was \$9.1 million and \$1.8 million, respectively. In addition, NLC's insurance companies may only pay dividends out of their earned surplus.

## Table of Contents

Statutory accounting principles. Statutory accounting principles (“SAP”) are a comprehensive basis of accounting developed to assist insurance regulators in monitoring and regulating the solvency of insurance companies. SAP rules are different from GAAP, and are intended to reflect a more conservative view of the insurer. SAP is primarily concerned with measuring an insurer’s surplus to policyholders. Accordingly, SAP focuses on valuing assets and liabilities of insurers at financial reporting dates in accordance with insurance laws and regulatory provisions applicable in each insurer’s domiciliary state.

While GAAP is concerned with a company’s solvency, it also stresses other financial measurements, such as income and cash flows. Accordingly, GAAP gives more consideration to appropriate matching of revenues and expenses and accounting for management’s stewardship of assets than does SAP. As a direct result, different amounts of assets and liabilities will be reflected in financial statements prepared in accordance with GAAP as opposed to SAP. SAP, as established by the NAIC and adopted by Texas regulators, determines the statutory surplus and statutory net income of the NLC insurance companies and, thus, determines the amount they have available to pay dividends.

Guaranty associations. In Texas, and in all of the jurisdictions in which NLIC and ASIC are, or in the future may be, licensed to transact business, there is a requirement that property and casualty insurers doing business within the jurisdiction must participate in guaranty associations, which are organized to pay limited covered benefits owed pursuant to insurance policies issued by impaired, insolvent or failed insurers. These associations levy assessments, up to prescribed limits, on all member insurers in a particular state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. States generally permit member insurers to recover assessments paid through full or partial premium tax offsets.

NLC did not incur any levies from guaranty associations in 2018, 2017 or 2016. Property and casualty insurance company insolvencies or failures may, however, result in additional guaranty fund assessments at some future date. At this time NLC is unable to determine the impact, if any, that these assessments may have on its financial condition or results of operations. NLC has established liabilities for guaranty fund assessments with respect to insurers that are currently subject to insolvency proceedings.

National Flood Insurance Program. NLC’s insurance subsidiary, NLIC, has entered into a production agreement with Wright National Flood Insurance Services, LLC (“Wright Flood Services”), a managing general underwriter and agency, that services flood insurance programs, including but not limited to Write Your Own flood insurance in the National Flood Insurance Program administered by the Federal Insurance and Mitigation Administration on behalf of the Federal Emergency Management Agency. NLIC produces and submits flood insurance business with Wright Flood Services.

Participation in involuntary risk plans. NLC’s insurance companies are required to participate in residual market or involuntary risk plans in various states where they are licensed that provide insurance to individuals or entities that otherwise would be unable to purchase coverage from private insurers. If these plans experience losses in excess of

their capitalization, they may assess participating insurers for proportionate shares of their financial deficit. These plans include the Georgia Underwriting Association, Texas FAIR Plan Association, Texas Windstorm Insurance Agency, the Louisiana Citizens Property Insurance Corporation, the Mississippi Residential Property Insurance Underwriting Association and the Mississippi Windstorm Underwriting Association. To address a 2016 deficit and losses resulting from Hurricane Harvey in 2017, the Texas FAIR Plan Association levied an assessment on participating companies totaling \$55.0 million, of which NLC's insurance subsidiaries' share was \$0.6 million. In addition, the Texas Windstorm Insurance Agency levied an assessment on participating companies totaling \$175.0 million, of which NLC's insurance subsidiaries' share was \$1.6 million. For comparative purposes, in 2005, following Hurricanes Katrina and Rita, NLC's insurance subsidiaries were levied collective assessments by the above plans totaling \$10.4 million. Additional assessments, including emergency assessments, may follow. In some of these instances, NLC's insurance companies should be able to recover these assessments through policyholder surcharges, higher rates or reinsurance. The ultimate impact hurricanes have on state facilities is currently uncertain and future assessments can occur whenever the involuntary facilities experience financial deficits.

Other. Insurance activities are subject to state insurance laws and regulations as determined by the particular insurance commissioner for each state in accordance with the McCarran-Ferguson Act, as well as subject to the Gramm-Leach-Bliley Act and the privacy regulations promulgated by the Federal Trade Commission.

Changes in any of the laws governing our conduct could have an adverse impact on our ability to conduct our business or could materially affect our financial position, operating income, expense or cash flow.

Table of Contents

Item 1A. Risk Factors.

The following discussion sets forth what management currently believes could be the most significant regulatory, market and economic, liquidity, legal and business and operational risks and uncertainties that could impact our business, results of operations and financial condition. Other risks and uncertainties, including those not currently known to us, could also negatively impact our business, results of operations and financial condition. Thus, the following should not be considered a complete discussion of all of the risks and uncertainties we may face, and the order of their respective significance may change.

Risks Related to our Business

If our allowance for loan losses is insufficient to cover actual loan losses, our banking segment earnings will be adversely affected.

As a lender, we are exposed to the risk that we could sustain losses because our borrowers may not repay their loans in accordance with the terms of their loans. We have historically accounted for this risk by maintaining an allowance for loan losses in an amount intended to cover Bank management's estimate of losses inherent in the loan portfolio. Under the acquisition method of accounting requirements, we were required to estimate the fair value of the loan portfolios acquired in each of the PlainsCapital Merger, the FNB Transaction, the January 2015 acquisition by merger of SWS for stock and cash consideration (the "SWS Merger") and the BORO Acquisition (collectively, the "Bank Transactions") as of the applicable acquisition date and write down the recorded value of each such acquired portfolio to the applicable estimate. For most loans, this process was accomplished by computing the net present value of estimated cash flows to be received from borrowers of such loans. The allowance for loan losses that had been maintained by PCC, FNB, SWS or BORO, as applicable, prior to their respective transactions, was eliminated in this accounting process. A new allowance for loan losses has been established for loans made by the Bank subsequent to consummation of the PlainsCapital Merger and for any decrease from that originally estimated as of the applicable acquisition date in the estimate of cash flows to be received from the loans acquired in the Bank Transactions.

The estimates of fair value as of the consummation of each of the Bank Transactions were based on economic conditions at such time and on Bank management's projections concerning both future economic conditions and the ability of the borrowers to continue to repay their loans. If management's assumptions and projections prove to be incorrect, however, the estimate of fair value may be higher than the actual fair value and we may suffer losses in excess of those estimated. Further, the allowance for loan losses established for new loans or for revised estimates may prove to be inadequate to cover actual losses, especially if economic conditions worsen.



Further, the measure of our allowance for loan losses is also dependent on the adoption of new accounting standards. On June 16, 2016, the Financial Accounting Standards Board issued the Current Expected Credit Loss (“CECL”) standard, which will require financial institutions to estimate and develop a provision for credit losses at origination for the lifetime of the loan, as opposed to reserving for incurred or probable losses up to the balance sheet date. Under the CECL model, credit deterioration would be reflected in the income statement in the period of origination or acquisition of the loan, with changes in expected credit losses due to further credit deterioration or improvement reflected in the periods in which the expectation changes. Accordingly, the CECL model may require the Bank to increase its allowance for loan losses. Moreover, the CECL model could create more volatility in the Bank’s level of allowance for loan losses.

While Bank management will endeavor to estimate the allowance to cover anticipated losses in our loan portfolio, no underwriting and credit monitoring policies and procedures that we could adopt to address credit risk could provide complete assurance that we will not incur unexpected losses. These losses could have a material adverse effect on our business, financial condition, results of operations and cash flows. In addition, federal regulators periodically evaluate the adequacy of our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs based on judgments different from those of Bank management. Any such increase in our provision for loan losses or additional loan charge-offs could have a material adverse effect on our results of operations and financial condition.

## Table of Contents

Our business is subject to interest rate risk, and fluctuations in interest rates may adversely affect our earnings, capital levels and overall results.

The majority of our assets are monetary in nature and, as a result, we are subject to significant risk from changes in interest rates. Between December 2016 and December 2018, the Federal Open Market Committee of the Federal Reserve Board raised its target range for short-term interest rates by 200 basis points, and further increases to the target rate may occur in 2019. Changes in interest rates may impact our net interest income in our banking segment as well as the valuation of our assets and liabilities in each of our segments. Earnings in our banking segment are significantly dependent on our net interest income, which is the difference between interest income on interest-earning assets, such as loans and securities, and interest expense on interest-bearing liabilities, such as deposits and borrowings. We expect to periodically experience “gaps” in the interest rate sensitivities of our banking segment’s assets and liabilities, meaning that either our interest-bearing liabilities will be more sensitive to changes in market interest rates than our interest-earning assets, or vice versa. In either event, if market interest rates should move contrary to our position, this “gap” may work against us, and our results of operations and financial condition may be adversely affected. Moreover, increases in interest rates could also lead to increases in our loan losses. Asymmetrical changes in interest rates, such as if short-term rates increase at a faster rate than long-term rates, can affect the slope of the yield curve. A decline in the yield curve or a flatter or inverted yield curve, which occurred at points during the fourth quarter of 2018 and the first quarter of 2019, could adversely impact the net interest income of our banking segment because our liabilities tend to be more sensitive to short-term rates while our assets tend to be more sensitive to long-term rates. In addition, it may take longer for our assets to reprice to adjust to a new rate environment because fixed-rate loans do not fluctuate with interest rate changes and adjustable rate loans often have a specified period of readjustment. As a result, a flattening or an inversion of the yield curve is likely to have a negative impact on our net interest income and our net interest margin.

An increase in the general level of interest rates may also, among other things, adversely affect the demand for loans and our ability to originate loans. In particular, if mortgage interest rates increase, the demand for residential mortgage loans and the refinancing of residential mortgage loans will likely decrease, which will have an adverse effect on our income generated from mortgage origination activities. Conversely, a decrease in the general level of interest rates, among other things, may lead to prepayments on our loan and mortgage-backed securities portfolios and increased competition for deposits. Accordingly, changes in the general level of market interest rates may adversely affect our net yield on interest-earning assets, loan origination volume and our overall results.

Our broker-dealer segment holds securities, principally fixed-income bonds, to support sales, underwriting and other customer activities. If interest rates increase, the value of debt securities held in the broker-dealer segment’s inventory would decrease. Rapid or significant changes in interest rates could adversely affect the segment’s bond sales, underwriting activities and broker-dealer businesses. Further, the profitability of our margin and stock lending businesses depends to a great extent on the difference between interest income earned on loans and investments of customer cash balances and the interest expense paid on customer cash balances and borrowings.

At December 31, 2018, approximately 84% of our insurance segment’s invested assets were invested in fixed maturity assets such as bonds and mortgage-backed securities. Because bond trading prices decrease as interest rates rise, a

significant increase in interest rates could have a material adverse effect on our insurance segment's financial condition and results of operations. On the other hand, decreases in interest rates could have an adverse effect on our insurance segment's investment income and results of operations. For example, if interest rates decline, investment of new premiums received and funds reinvested will earn less. Additionally, mortgage-backed securities are typically prepaid more quickly when interest rates fall and the holder must reinvest the proceeds at lower interest rates. In periods of increasing interest rates, mortgage-backed securities are typically prepaid more slowly, which may result in our insurance segment receiving interest payments that are below the then-prevailing interest rates for longer time periods than expected. The volatility of our insurance segment's claims may force it to liquidate securities, which may cause it to incur capital losses. If our insurance segment's investment portfolio is not appropriately matched with its insurance liabilities, it may be forced to liquidate investments prior to maturity at a significant loss to cover these liabilities. In addition, if we experience market disruption and volatility, such as that experienced in 2009 and 2010, we may experience additional losses on our investments and reductions in our earnings. Investment losses could significantly decrease the asset base and statutory surplus of our insurance segment, thereby adversely affecting its ability to conduct business and potentially its A.M. Best financial strength rating.

In addition, we hold securities that may be sold in response to changes in market interest rates, changes in securities' prepayment risk, increases in loan demand, general liquidity needs and other similar factors. Such securities are classified

Table of Contents

as available for sale and are carried at estimated fair value, which may fluctuate with changes in market interest rates. The effects of an increase in market interest rates may result in a decrease in the value of our available for sale investment portfolio.

Market interest rates are affected by many factors outside of our control, including inflation, recession, unemployment, money supply, international disorder and instability in domestic and foreign financial markets. We may not be able to accurately predict the likelihood, nature and magnitude of such changes or how and to what extent such changes may affect our business. We also may not be able to adequately prepare for, or compensate for, the consequences of such changes. Any failure to predict and prepare for changes in interest rates, or adjust for the consequences of these changes, may adversely affect our earnings and capital levels and overall results of operations and financial condition.

Our business and results of operations may be adversely affected by unpredictable economic, market and business conditions.

Our business and results of operations are affected by general economic, market and business conditions. The credit quality of our loan portfolio necessarily reflects, among other things, the general economic conditions in the areas in which we conduct our business. Our continued financial success depends to a degree on factors beyond our control, including:

- national and local economic conditions, such as the level and volatility of short-term and long-term interest rates, inflation, home prices, unemployment and under-employment levels, energy prices, bankruptcies, household income and consumer spending;
- the availability and cost of capital and credit;
- incidence of customer fraud; and
- federal, state and local laws affecting these matters.

The deterioration of any of these conditions, as we have experienced with past economic downturns, could adversely affect our consumer and commercial businesses and securities portfolios, our level of loan charge-offs and provision for loan losses, the carrying value of our deferred tax assets, the investment portfolio of our insurance segment, our capital levels and liquidity, our securities underwriting business and our results of operations.

Several factors could pose risks to the financial services industry, including slowing growth in emerging economies, trade wars, international political unrest, increases in interest rates, regulatory uncertainty, continued infrastructure deterioration and low oil prices. In addition, the current environment of heightened scrutiny of financial institutions has resulted in increased public awareness of and sensitivity to banking fees and practices. Each of these factors may adversely affect our fees and costs.

Over the last several years, there have been several instances where there has been uncertainty regarding the ability of Congress and the President collectively to reach agreement on federal budgetary and spending matters. A period of failure to reach agreement on these matters, particularly if accompanied by an actual or threatened government shutdown, may have an adverse impact on the U.S. economy. Additionally, a prolonged government shutdown may inhibit our ability to evaluate borrower creditworthiness and originate and sell certain government-backed loans.

The financial services industry is characterized by rapid technological change, and if we fail to keep pace, our business may suffer.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively or timely implement new technology-driven products and services or be successful in marketing these products and services to our customers and clients. Failure to successfully keep pace with technological change affecting the financial services industry and avoid interruptions, errors and delays could have a material adverse impact on our business, financial condition, results of operations or cash flows.

## Table of Contents

We are heavily reliant on technology, and a failure to effectively implement new technological solutions or enhancements to existing systems or platforms could adversely affect our business operations and the financial results of our operations.

Like most financial services companies, we significantly depend on technology to deliver our products and services and to otherwise conduct business. To remain technologically competitive and operationally efficient, we have either begun the significant investment in or have plans to invest in new technological solutions, substantial core system upgrades and other technology enhancements within each of our operating segments and corporate. Many of these solutions and enhancements have a significant duration, include phased implementation schedules, are tied to critical systems, and require substantial internal and external resources for design and implementation. Such external resources may be relied upon to provide expertise and support to help implement, maintain and/or service certain of our core technology solutions.

Although we take steps to mitigate the risks and uncertainties associated with these solutions and initiatives, we may encounter significant adverse developments in the completion and implementation of these initiatives. These may include significant time delays, cost overruns, loss of key personnel, technological problems, processing failures, distraction of management and other adverse developments. Further, our ability to maintain an adequate control environment may be impacted.

The ultimate effect of any adverse development could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could materially affect us, including our control environment, operating efficiency, and results of operations.

Our geographic concentration may magnify the adverse effects and consequences of any regional or local economic downturn.

We conduct our banking operations primarily in Texas. At December 31, 2018, substantially all of the real estate loans in our loan portfolio were secured by properties located in our four largest markets within Texas, with 39%, 23%, 17% and 5% secured by properties located in the Dallas/Fort Worth, Austin/San Antonio, Houston/Coastal Bend and Rio Grande Valley/South Texas markets, respectively. Substantially all of these loans are made to borrowers who live and conduct business in Texas. Accordingly, economic conditions in Texas have a significant impact on the ability of the Bank's customers to repay loans, the value of the collateral securing loans, our ability to sell the collateral upon any foreclosure, and the stability of the Bank's deposit funding sources. Further, low crude oil prices may have a more profound effect on the economy of energy-dominant states such as Texas. The Bank has loans extended to businesses that depend on the energy industry including those within the exploration and production, oilfield services, pipeline construction, distribution and transportation sectors. If crude oil prices decrease and remain depressed for an extended period, the Bank could experience weaker energy loan demand and increased losses within its energy and Texas-related loan portfolios. Moreover, natural disasters, such as Hurricane Harvey in 2017, may also have an adverse impact on local economic conditions.

In addition, mortgage origination fee income and insurance premium volume are both dependent to a significant degree on economic conditions in Texas and California. During 2018, 19.0% and 11.0% of our mortgage loans originated (by dollar volume) were collateralized by properties located in Texas and California, respectively. Further, Texas insureds accounted for 68.2% and 68.8% of our insurance segment's gross premiums written in 2018 and 2017, respectively. Also, in our broker-dealer segment, 70% of public finance department net revenues were from entities located in Texas, and 91% of retail brokerage service revenues were generated through locations in Texas, California and Oklahoma. Any regional or local economic downturn that affects Texas or, to a lesser extent, California or Oklahoma, whether caused by recession, inflation, unemployment, changing oil prices, natural disasters or other factors, may affect us and our profitability more significantly and more adversely than our competitors that are less geographically concentrated, and could have a material adverse effect on our results of operations and financial condition.

An adverse change in real estate market values may result in losses in our banking segment and otherwise adversely affect our profitability.

At December 31, 2018, 48% of the loan portfolio of our banking segment was comprised of loans with real estate as the primary component of collateral. The real estate collateral in each case provides a source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. A decline in real estate values generally, and in Texas specifically, could impair the value of the collateral underlying a significant portion of the Bank's loan portfolio and our ability to sell the collateral upon any foreclosure. In the event of a default with respect to any of

## Table of Contents

these loans, the amounts we receive upon sale of the collateral may be insufficient to recover the outstanding principal and interest on the loan. As a result, our results of operations and financial condition may be materially adversely affected by a decrease in real estate market values.

Our operational systems and networks have been, and will continue to be, subject to an increasing risk of continually evolving cybersecurity or other technological risks, which could result in a loss of customer business, financial liability, regulatory penalties, damage to our reputation or the disclosure of confidential information.

We rely heavily on communications and information systems to conduct our business and maintain the security of confidential information and complex transactions, which subjects us to an increasing risk of cyber incidents from these activities due to a combination of new technologies and the increasing use of the Internet to conduct financial transactions, as well as a potential failure, interruption or breach in the security of these systems, including those that could result from attacks or planned changes, upgrades and maintenance of these systems. Such cyber incidents could result in failures or disruptions in our customer relationship management, securities trading, general ledger, deposits, computer systems, electronic underwriting servicing or loan origination systems. We also utilize relationships with third parties to aid in a significant portion of our information systems, communications, data management and transaction processing. These third parties with which we do business may also be sources of cybersecurity or other technological risks, including operational errors, system interruptions or breaches, unauthorized disclosure of confidential information and misuse of intellectual property. If our third-party service providers encounter any of these issues, we could be exposed to disruption of service, reputation damages, and litigation risk, any of which could have a material adverse effect on our business.

The recent occurrence of cybersecurity incidents across a range of industries has resulted in increased legislative and regulatory scrutiny over cybersecurity and calls for additional data privacy laws and regulations. For example, in 2018, the State of California adopted the California Consumer Privacy Act of 2018, which imposes requirements on companies operating in California and provides consumers with a private right of action if covered companies suffer a data breach related to their failure to implement reasonable security measures. These laws and regulations could result in increased operating expenses or increase our exposure to the risk of litigation.

Although we devote significant resources to maintain and regularly upgrade our systems and networks to safeguard critical business applications, there is no guarantee that these measures or any other measures can provide absolute security. Our computer systems, software and networks may be adversely affected by cyber incidents such as unauthorized access; loss or destruction of data (including confidential client information); account takeovers; unavailability of service; computer viruses or other malicious code; cyber-attacks; and other events. In addition, our protective measures may not promptly detect intrusions, and we may experience losses or incur costs or other damage related to intrusions that go undetected or go undetected for significant periods of time, at levels that adversely affect our financial results or reputation. Further, because the methods used to cause cyber attacks change frequently, or in some cases cannot be recognized until launched, we may be unable to implement preventative measures or proactively address these methods until they are discovered. Cyber threats may derive from human error, fraud or malice on the part of employees or third parties, or may result from accidental technological failure. For example, during the second quarter of 2018, we became the victim of a “spear phishing” attack on one of our employees in which we suffered a \$4.0



million wire fraud loss and sensitive customer information was stolen. As a result of this attack, we incurred costs to provide identity protections services, including credit monitoring, to customers who may have been impacted and other legal and professional services, and may also incur expenses in the future including legal and professional expenses and claims for damages. Additional challenges are posed by external extremist parties, including foreign state actors, in some circumstances, as a means to promote political ends. If one or more of these events occurs, it could result in the disclosure of confidential client or customer information, damage to our reputation with our clients, customers and the market, customer dissatisfaction, additional costs such as repairing systems or adding new personnel or protection technologies, regulatory penalties, fines, remediation costs, exposure to litigation and other financial losses to both us and our clients and customers. Such events could also cause interruptions or malfunctions in our operations. We maintain cyber risk insurance, but this insurance may not be sufficient to cover all of our losses from any future breaches of our systems.

We continue to evaluate our cybersecurity program and will consider incorporating new practices as necessary to meet the expectations of such regulatory agencies in light of such cybersecurity guidance and regulatory actions and settlements for cybersecurity-related failures and violations by other industry participants. Such procedures include management-level engagement and corporate governance, risk management and assessment, technical controls, incident response planning, vulnerability testing, vendor management and staff training. Even if we implement these procedures, however, we cannot

Table of Contents

assure you that we will be fully protected from a cybersecurity incident, the occurrence of which could adversely affect our reputation and financial condition.

Our mortgage origination and insurance businesses are subject to fluctuations based upon seasonal and other factors and, as a result, our results of operations for any given quarter may not be indicative of the results that may be achieved for the full fiscal year.

Our mortgage origination business is subject to several variables that can impact loan origination volume, including seasonal and interest rate fluctuations. We typically experience increased loan origination volume from purchases of homes during the second and third calendar quarters, when more people tend to move and buy or sell homes. In addition, an increase in the general level of interest rates may, among other things, adversely affect the demand for mortgage loans and our ability to originate mortgage loans. In particular, if mortgage interest rates increase, the demand for residential mortgage loans and the refinancing of residential mortgage loans will likely decrease, which will have an adverse effect on our mortgage origination activities. Conversely, a decrease in the general level of interest rates, among other things, may lead to increased competition for mortgage loan origination business.

Generally, our insurance segment's insured risks exhibit higher losses in the second and third calendar quarters due to a seasonal concentration of weather-related events in its primary geographic markets. Although weather-related losses (including hail, high winds, tornadoes, monsoons and hurricanes) can occur in any calendar quarter, the second calendar quarter, historically, has experienced the highest frequency of losses associated with these events. Hurricanes, however, are more likely to occur in the third calendar quarter of the year.

As a result of these variables, our results of operations for any single quarter are not necessarily indicative of the results that may be achieved for a full fiscal year.

Our geographic concentration may exacerbate the adverse effects on our insurance segment of inherently unpredictable catastrophic events.

Our insurance segment expects to have large aggregate exposures to inherently unpredictable natural and man-made disasters of great severity, such as hurricanes, hail, tornados, windstorms, wildfires and acts of terrorism. The catastrophe models utilized by our insurance segment to assess its probable maximum insurance losses have, in the past, failed to adequately project the financial impact of hurricanes. Although our insurance segment may attempt to exclude certain losses, such as terrorism and other similar risks, from some coverage that our insurance segment writes, it may be prohibited from, or may not be successful in, doing so. The occurrence of losses from catastrophic events may have a material adverse effect on our insurance segment's ability to write new business and on its financial condition and results of operations. Increases in the values and geographic concentrations of policyholder property and the effects of inflation have resulted in increased severity of industry losses in recent years, and our insurance

segment expects that these factors will increase the severity of losses in the future. Factors that may influence our insurance segment's exposure to losses from these types of events, in addition to the routine adjustment of losses, include, among others:

- exhaustion of reinsurance coverage;
- increases in reinsurance rates;
- unanticipated litigation expenses;
- unrecoverability of ceded losses;
- impact on independent agent operations and future premium income in areas affected by catastrophic events;
- unanticipated expansion of policy coverage or reduction of premium due to regulatory, legislative and/or judicial action following a catastrophic event; and
- unanticipated demand surge related to other recent catastrophic events.

Our insurance segment writes insurance primarily in the states of Texas, Arizona, Tennessee, Oklahoma and Georgia. In 2018, Texas accounted for 68.2%, Arizona accounted for 11.4%, Tennessee accounted for 7.0%, Oklahoma accounted for 5.7% and Georgia accounted for 3.2% of our gross premiums written. As a result, a single catastrophe, destructive weather pattern, wildfire, terrorist attack, regulatory development or other condition or general economic trend affecting any of these regions or significant portions of any of these regions could adversely affect our insurance segment's

Table of Contents

financial condition and results of operations more significantly than other insurance companies that conduct business across a broader geographic area. Although our insurance segment purchases catastrophe reinsurance to limit its exposure to these types of catastrophes, in the event of one or more major catastrophes resulting in losses to it in excess of \$105.0 million, our insurance segment's losses would exceed the limits of its reinsurance coverage.

Our risk management processes may not fully identify and mitigate exposure to the various risks that we face, including interest rate, credit, liquidity and market risk.

We continue to refine our risk management techniques, strategies and assessment methods on an ongoing basis. However, our risk management techniques and strategies (as well as those available to the market generally) may not be fully effective in mitigating our risk exposure in all economic market environments or against all types of risk. For example, we might fail to identify or anticipate particular risks, or the systems that we use, and that are used within our business segments generally, may not be capable of identifying certain risks. Certain of our strategies for managing risk are based upon observed historical market behavior. We apply statistical and other tools to these observations to quantify our risk exposure. Any failures in our risk management techniques and strategies to accurately identify and quantify our risk exposure could limit our ability to manage risks. In addition, any risk management failures could cause our losses to be significantly greater than the historical measures indicate. Further, our quantified modeling does not take all risks into account. As a result, we also take a qualitative approach in reducing our risk, although our qualitative approach to managing those risks could also prove insufficient, exposing us to material unanticipated losses.

Our bank lending, margin lending, stock lending, securities trading and execution and mortgage purchase businesses are all subject to credit risk.

We are exposed to credit risk in all areas of our business. The Bank is exposed to the risk that its loan customers may not repay their loans in accordance with their terms, the collateral securing the loans may be insufficient, or its loan loss reserve may be inadequate to fully compensate the Bank for the outstanding balance of the loan plus the costs to dispose of the collateral. Further, our mortgage warehousing activities subject us to credit risk during the period between funding by the Bank and when the mortgage company sells the loan to a secondary investor.

Our broker-dealer business is subject to credit risk if securities prices decline rapidly because the value of our collateral could fall below the amount of the indebtedness it secures. In rapidly appreciating markets, credit risk increases due to short positions. Our securities lending business as well as our securities trading and execution businesses subject us to credit risk if a counterparty fails to perform or if collateral securing its obligations is insufficient. In securities transactions, we are subject to credit risk during the period between the execution of a trade and the settlement by the customer.

Significant failures by our customers, including correspondents, or clients to honor their obligations, or increases in their rates of default, together with insufficient collateral and reserves, could have a material adverse effect on our business, financial condition, results of operations or cash flows.

We depend on our computer and communications systems and an interruption in service would negatively affect our business.

Our businesses rely on electronic data processing and communications systems. The effective use of technology allows us to better serve customers and clients, increases efficiency and reduces costs. Our continued success will depend, in part, upon our ability to successfully maintain, secure and upgrade the capability of our systems, our ability to address the needs of our clients by using technology to provide products and services that satisfy their demands and our ability to retain skilled information technology employees. Significant malfunctions or failures of our computer systems, computer security, software or any other systems in the trading process (e.g., record retention and data processing functions performed by third parties, and third party software, such as Internet browsers) could cause delays in customer trading activity. Such delays could cause substantial losses for customers and could subject us to claims from customers for losses, including litigation claiming fraud or negligence. In addition, if our computer and communications systems fail to operate properly, regulations would restrict our ability to conduct business. Any such failure could prevent us from collecting funds relating to customer and client transactions, which would materially impact our cash flows. Any computer or communications system failure or decrease in computer system performance that causes interruptions in our operations could have a material adverse effect on our business, financial condition, results of operations or cash flows.

## Table of Contents

We are heavily dependent on dividends from our subsidiaries.

We are a financial holding company engaged in the business of managing, controlling and operating our subsidiaries. Hilltop conducts limited material business other than activities incidental to holding stock in the Bank, Securities Holdings and NLC. As a result, we rely substantially on the profitability of, and dividends from, these subsidiaries to pay our operating expenses and to pay interest on our debt obligations. Each of the Bank, Securities Holdings and NLC is subject to significant regulatory restrictions limiting its ability to declare and pay dividends to us. Accordingly, if the Bank, Securities Holdings or NLC are unable to make cash distributions to us, then we may be unable to satisfy our operating expense obligations or make interest payments on our debt obligations.

NLIC and ASIC are also subject to limitations under debt agreements limiting their ability to declare and pay dividends, including the surplus indentures governing NLIC's two London Interbank Offered Rate ("LIBOR") plus 4.10% and 4.05% notes due May and September 2033, respectively, and ASIC's LIBOR plus 4.05% notes due April 2034.

Our indebtedness may affect our ability to operate our business, and may have a material adverse effect on our financial condition and results of operations. We may incur additional indebtedness, including secured indebtedness.

At December 31, 2018, on a consolidated basis, we had total deposits of \$8.5 billion and other indebtedness of \$1.4 billion, including \$150.0 million in aggregate principal amount of 5% senior notes due 2025 (the "Senior Notes"). Our significant amount of indebtedness could have important consequences, such as:

- limiting our ability to obtain additional financing to fund our working capital needs, acquisitions, capital expenditures or other debt service requirements or for other purposes;
- limiting our ability to use operating cash flow in other areas of our business because we must dedicate a substantial portion of these funds to service debt;
- limiting our ability to compete with other companies who are not as highly leveraged, as we may be less capable of responding to adverse economic and industry conditions;
- restricting us from making strategic acquisitions, developing properties or pursuing business opportunities;
- restricting the way in which we conduct our business because of financial and operating covenants in the agreements governing our and certain of our subsidiaries' existing and future indebtedness, including, in the case of certain indebtedness of subsidiaries, certain covenants that restrict the ability of such subsidiaries to pay dividends or make other distributions to us;
- exposing us to potential events of default (if not cured or waived) under financial and operating covenants contained in our or our subsidiaries' debt instruments that could have a material adverse effect on our business, financial condition and operating results;
- increasing our vulnerability to a downturn in general economic conditions or a decrease in pricing of our products; and
- limiting our ability to react to changing market conditions in our industry and in our customers' industries.

In addition to our debt service obligations, our operations require substantial investments on a continuing basis. Our ability to make scheduled debt payments, to refinance our obligations with respect to our indebtedness and to fund capital and non-capital expenditures necessary to maintain the condition of our operating assets and properties, as well as to provide capacity for the growth of our business, depends on our financial and operating performance, which, in turn, is subject to prevailing economic conditions and financial, business, competitive, legal and other factors.

Subject to the restrictions in the indenture governing the Senior Notes, we may incur significant additional indebtedness, including secured indebtedness. If new debt is added to our current debt levels, the risks described above could increase.

Table of Contents

We may not be able to generate sufficient cash to service all of our indebtedness, including the Senior Notes, and may be forced to take other actions to satisfy our obligations under our indebtedness that may not be successful.

Our ability to satisfy our debt obligations will depend upon, among other things:

- our future financial and operating performance, which will be affected by prevailing economic conditions and financial, business, regulatory and other factors, many of which are beyond our control; and
- our future ability to refinance the Senior Notes, which depends on, among other things, our compliance with the covenants in the indenture governing the Senior Notes.

We cannot assure you that our business will generate sufficient cash flow from operations, or that we will be able to obtain financing in an amount sufficient to fund our liquidity needs.

If our cash flows and capital resources are insufficient to service our indebtedness, including the Senior Notes, we may be forced to reduce or delay capital expenditures, sell assets, seek additional capital or restructure or refinance our indebtedness, including the Senior Notes. These alternative measures may not be successful and may not permit us to meet our scheduled debt service obligations, including our obligations under the Senior Notes. Our ability to restructure or refinance our debt will depend on the condition of the capital markets and our financial condition at such time. Any refinancing of our debt could be at higher interest rates and may require us to comply with more onerous covenants, which could further restrict our business operations. In addition, the terms of existing or future debt agreements may restrict us from adopting some of these alternatives. In the absence of such operating results and resources, we could face substantial liquidity problems and might be required to dispose of material assets or operations, sell equity and/or negotiate with our lenders and other creditors to restructure the applicable debt in order to meet our debt service and other obligations. We may not be able to consummate those dispositions for fair market value or at all. The indenture governing the Senior Notes may restrict, or market or business conditions may limit, our ability to avail ourselves of some or all of these options. Furthermore, any proceeds that we could realize from any such dispositions may not be adequate to meet our debt service obligations then due.

A reduction in our credit rating could adversely affect us or the holders of our securities.

The credit rating agencies rating our indebtedness regularly evaluate the Company, and credit ratings are based on a number of factors, including our financial strength and ability to generate earnings, as well as factors not entirely within our control, including conditions affecting the financial services industry and the economy and changes in rating methodologies. There can be no assurance that we will maintain our current credit rating. A downgrade of our credit rating could adversely affect our access to liquidity and capital, and could significantly increase our cost of funds, trigger additional collateral or funding requirements and decrease the number of investors and counterparties willing to lend to us or purchase our securities. This could affect our growth, profitability and financial condition, including liquidity.



The indenture governing the Senior Notes contains, and any instruments governing future indebtedness would likely contain, restrictions that limit our flexibility in operating our business.

The indenture governing the Senior Notes contains, and any instruments governing future indebtedness would likely contain, a number of covenants that impose significant operating and financial restrictions on us, including restrictions on our ability to, among other things:

- dispose of, or issue voting stock of, certain subsidiaries; or
  - incur or permit to exist any mortgage, pledge, encumbrance or lien or charge on the capital stock of certain subsidiaries.

Any of these restrictions could limit our ability to plan for or react to market conditions and could otherwise restrict corporate activities. Any failure to comply with these covenants could result in a default under the indenture governing the Senior Notes. Upon a default, holders of the Senior Notes have the ability ultimately to force us into bankruptcy or liquidation, subject to the indenture governing the Senior Notes. In addition, a default under the indenture governing the Senior Notes could trigger a cross default under the agreements governing our existing and future indebtedness. Our operating results may not be sufficient to service our indebtedness or to fund our other expenditures and we may not be able to obtain financing to meet these requirements.

Table of Contents

We are subject to extensive supervision and regulation that could restrict our activities and impose financial requirements or limitations on the conduct of our business and limit our ability to generate income.

We are subject to extensive federal and state regulation and supervision, including that of the Federal Reserve Board, the Texas Department of Banking, the TDI, the FDIC, the CFPB, the SEC and FINRA. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not stockholders or other debt holders. Insurance regulations promulgated by state insurance departments are primarily intended to protect policyholders rather than stockholders or other debt holders. Likewise, regulations promulgated by the SEC and FINRA are primarily intended to protect the securities markets and customers of broker-dealer businesses rather than stockholders or other debt holders.

These regulations affect our lending practices, capital structure, capital requirements, investment practices, brokerage and investment advisory activities, dividends and growth, among other things. Failure to comply with laws, regulations or policies could result in money damages, civil money penalties or reputational damage, as well as sanctions and supervisory actions by regulatory agencies that could subject us to significant restrictions on or suspensions of our business and our ability to expand through acquisitions or branching. Further, our clearing contracts generally include automatic termination provisions that are triggered in the event we are suspended from any of the national exchanges of which we are a member for failure to comply with the rules or regulations thereof. While we have implemented policies and procedures designed to prevent any such violations of rules and regulations, such violations may occur from time to time, which could have a material adverse effect on our financial condition and results of operations.

The U.S. Congress, state legislatures, and federal and state regulatory agencies frequently revise banking and securities laws, regulations and policies. For example, several aspects of the Dodd-Frank Act have affected our business, including, without limitation, increased capital requirements, increased mortgage regulation, restrictions on proprietary trading in securities, restrictions on investments in hedge funds and private equity funds, executive compensation restrictions, potential federal oversight of the insurance industry and disclosure and reporting requirements. Although the recently enacted EGRRCPA is intended to ease the regulatory burden imposed by the Dodd-Frank Act with respect to company-run stress testing, resolution plans, the Volcker Rule, high volatility commercial real estate exposures, and real estate appraisals, at this time, it remains difficult to predict the full extent to which the Dodd-Frank Act and the EGRRCPA or the resulting rules and regulations will affect our business. Compliance with new laws and regulations has resulted and likely will continue to result in additional costs, which could be significant and may adversely impact our results of operations, financial condition, and liquidity.

The Bank received a "satisfactory" CRA rating in connection with its most recent CRA performance evaluation. A CRA rating of less than "satisfactory" adversely affects a bank's ability to establish new branches and impairs a bank's ability to commence new activities that are "financial in nature" or acquire companies engaged in these activities. Other regulatory exam ratings or findings also may adversely impact our ability to branch, commence new activities or make acquisitions.

We cannot predict whether or in what form any other proposed regulations or statutes will be adopted or the extent to which our business may be affected by any new regulation or statute. These changes become less predictable, yet more likely to occur, following the transition of power from one presidential administration to another, especially as in 2017, when it involves a change in political party. Any such changes could subject our business to additional costs, limit the types of financial services and products we may offer and increase the ability of non-banks to offer competing financial services and products, among other things.

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

In July 2013, the Federal Reserve Board approved a final rule that substantially amends the risk-based capital rules applicable to Hilltop and PlainsCapital. The final rule implements the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The final rule includes new minimum risk-based capital and leverage ratios, which became effective on a phase-in basis for Hilltop and PlainsCapital from January 1, 2015 through January 1, 2019, and refines the definition of what constitutes “capital” for purposes of calculating these ratios. The final rule also establishes a “capital conservation buffer” of 2.5% above the new regulatory minimum capital ratios. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions. The application of more stringent capital requirements for Hilltop and PlainsCapital could, among other things, adversely affect our results of operations and growth, require the raising of

Table of Contents

additional capital, restrict our ability to pay dividends or repurchase shares and result in regulatory actions if we were to be unable to comply with such requirements.

Banks with \$10.0 billion in total consolidated assets are primarily examined by the CFPB with respect to various consumer financial protection laws and regulations. At December 31, 2018, Hilltop and PlainsCapital had \$13.7 billion and \$10.1 billion, respectively, in total consolidated assets and their average of total consolidated assets for the four most recent consecutive quarters was \$13.6 billion and \$9.8 billion, respectively. As a relatively new agency with evolving regulations and practices, there is uncertainty as to how the CFPB's examination and regulatory authority might impact the Company's and PlainsCapital's businesses.

Periodically, the SEC adopts amendments to Rules 15c3-1 and 15c3-3 under the Exchange Act related to our broker-dealer segment. The implementation of any new requirements from these amendments may increase our cost of regulatory compliance.

The CFPB has issued "ability-to-repay" and "qualified mortgage" rules that may have a negative impact on our loan origination process and foreclosure proceedings, which could adversely affect our business, operating results, and financial condition.

On January 10, 2013, the CFPB issued a final rule to implement the "qualified mortgage" provisions of the Dodd-Frank Act requiring mortgage lenders to consider consumers' ability to repay home loans before extending them credit. The CFPB's "qualified mortgage" rule took effect on January 10, 2014. The final rule describes certain minimum requirements for lenders making ability-to-repay determinations, but does not dictate that they follow particular underwriting models. Lenders are presumed to have complied with the ability-to-repay rule if they issue "qualified mortgages," which are generally defined as mortgage loans prohibiting or limiting certain risky features. Loans that do not meet the ability-to-repay standard can be challenged in court by borrowers who default and the absence of ability-to-repay status can be used against a lender in foreclosure proceedings. Any loans that we make outside of the "qualified mortgage" criteria could expose us to an increased risk of liability and reduce or delay our ability to foreclose on the underlying property. Any increases in compliance and foreclosure costs caused by the rule could negatively affect our business, operating results and financial condition.

Our broker-dealer business is subject to various risks associated with the securities industry.

Our broker-dealer business is subject to uncertainties that are common in the securities industry. These uncertainties include:

- intense competition in the public banking and other sectors of the securities industry;
- the volatility of domestic and international financial, bond and stock markets;
- extensive governmental regulation;
- litigation; and
- substantial fluctuations in the volume and price level of securities.

As a result of such uncertainties, the revenues and operating results of our broker-dealer segment may vary significantly from quarter to quarter and from year to year. Unfavorable financial or economic conditions could reduce the number and size of transactions in which we provide financial advisory, underwriting and other services. Disruptions in fixed income and equity markets could lead to a decline in the volume of transactions executed for customers and, therefore, to declines in revenues from commissions and clearing services. Our broker-dealer business is much smaller and has much less capital than many competitors in the securities industry. In addition, the Hilltop Broker-Dealers are operating subsidiaries of Hilltop, which means that their activities are limited to those that are permissible for subsidiaries of a financial holding company.

Market fluctuations could adversely impact our broker-dealer business.

Our broker-dealer segment is subject to risks as a result of fluctuations in the securities markets. Our securities trading, market-making and underwriting activities involve the purchase and sale of securities as a principal, which subjects our capital to significant risks. Market conditions could limit our ability to sell securities purchased or to purchase securities sold in such transactions. If price levels for equity securities decline generally, the market value of equity securities that

Table of Contents

we hold in our inventory could decrease and trading volumes could decline. In addition, if interest rates increase, the value of debt securities we hold in our inventory would decrease. Rapid or significant market fluctuations could adversely affect our business, financial condition, results of operations and cash flow.

In addition, during periods of market disruption, it may be difficult to value certain assets if comparable sales become less frequent or market data becomes less observable. Certain classes of assets or loan collateral that were in active markets with significant observable data may become illiquid due to the current financial environment. In such cases, asset valuations may require more estimation and subjective judgment.

Our investment advisory business may be affected if our investment products perform poorly.

Poor investment returns and declines in client assets in our investment advisory business, due to either general market conditions or underperformance (relative to our competitors or to benchmarks) by investment products, may affect our ability to retain existing assets, prevent clients from transferring their assets out of products or their accounts, or inhibit our ability to attract new clients or additional assets from existing clients. Any such poor performance could adversely affect our investment advisory business and the advisory fees that we earn on client assets.

Our portfolio trading business is highly price competitive and serves a very limited market.

Our portfolio trading business serves one small component of the capital markets group with a small customer base and a high service model, charging competitive commission rates. Consequently, growing or maintaining market share is very price sensitive. We rely upon a high level of customer service and product customization to maintain our market share; however, should prevailing market prices fall, or the size of our market segment or customer base decline, our profitability would be adversely impacted. In addition, in our portfolio trading business, we purchase securities as principal, which subjects our capital to significant risks.

Our existing correspondents may choose to perform their own clearing services, move their clearing business to one of our competitors or exit the business.

As our correspondents' operations grow, they often consider the option of performing clearing functions themselves, in a process referred to as "self-clearing." The option to convert to self-clearing operations may be attractive due to the fact that as the transaction volume of a broker-dealer grows, the cost of implementing the necessary infrastructure for self-clearing may eventually be offset by the elimination of per transaction processing fees that would otherwise be paid to a clearing firm. Additionally, performing their own clearing services allows self-clearing broker-dealers to retain their customers' margin balances, free credit balances and securities for use in margin lending activities.

Furthermore, our correspondents may decide to use the clearing services of one of our competitors or exit the business. Any significant loss of correspondents due to self-clearing or because of their use of a competitor's clearing service or their exiting the business could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Several of our broker-dealer segment's product lines rely on favorable tax treatment and changes in federal tax law could impact the attractiveness of these products to our customers.

We offer a variety of services and products, such as individual retirement accounts and municipal bonds, which rely on favorable federal income tax treatment to be attractive to our customers. Should favorable tax treatment of these products be eliminated or reduced, sales of these products could be materially impacted, which could have a material adverse effect on our business, financial condition, results of operations or cash flows. For example, national municipal issuances surged in the fourth quarter of 2017 due to the then-anticipated effects of the Tax Cuts and Jobs Act, and a number of national municipal issuers elected to accelerate certain capital raising initiatives before these changes were enacted. As a result, we experienced lower municipal issuance volume in 2018, which adversely impacted the financial condition, results of operations and cash flows of our broker-dealer segment's public finance department.

Our mortgage origination segment is subject to investment risk on loans that it originates.

We intend to sell, and not hold for investment, substantially all residential mortgage loans that we originate through PrimeLending. At times, however, we may originate a loan or execute an interest rate lock commitment ("IRLC") with a customer pursuant to which we agree to originate a mortgage loan on a future date at an agreed-upon interest rate without having identified a purchaser for such loan. An identified purchaser may also decline to purchase a loan for a variety of reasons. In these instances, we will bear interest rate risk on an IRLC until, and unless, we are able to find a buyer for the

## Table of Contents

loan underlying such IRLC and the risk of investment on a loan until, and unless, we are able to find a buyer for such loan. In addition, in the event of a breach of any representation or warranty concerning a loan, an agency, investor or other third party could, among other things, require us to repurchase the full amount of the loan or seek indemnification for losses from us, even if the loan is not in default. Further, if a customer defaults on a mortgage payment shortly after the loan is originated, the purchaser of the loan may have a put right, whereby the purchaser can require us to repurchase the loan at the full amount that it paid. During periods of market downturn, we may choose to hold mortgage loans when the identified purchasers have declined to purchase such loans because we may not obtain an acceptable substitute bid price for such loan. The failure of mortgage loans that we hold on our books to perform adequately could have a material adverse effect on our financial condition, liquidity and results of operations. Moreover, if a property securing a mortgage loan on which we own the servicing rights is damaged, including from flooding, we may be responsible for repairs for uninsured damage.

Changes in interest rates may change the value of our mortgage servicing rights portfolio, which may increase the volatility of our earnings.

As a result of our mortgage servicing business, which we may expand in the future, we have a portfolio of MSR assets. A MSR is the right to service a mortgage loan – collect principal, interest and escrow amounts – for a fee. We measure and carry all of our residential MSR assets using the fair value measurement method. Fair value is determined as the present value of estimated future net servicing income, calculated based on a number of variables, including assumptions about the likelihood of prepayment by borrowers.

One of the principal risks associated with MSR assets is that in a declining interest rate environment, they will likely lose a substantial portion of their value as a result of higher than anticipated prepayments. Moreover, if prepayments are greater than expected, the cash we receive over the life of the mortgage loans would be reduced. The mortgage origination segment uses derivative financial instruments, including U.S. Treasury bond futures and options, as a means to mitigate market risk associated with MSR assets. However, no hedging strategy can protect us completely, and hedging strategies may fail because they are improperly designed, improperly executed and documented or based on inaccurate assumptions and, as a result, could actually increase our risks and losses. The increasing size of our MSR portfolio may increase our interest rate risk and correspondingly, the volatility of our earnings, especially if we cannot adequately hedge the interest rate risk relating to our MSR assets.

At December 31, 2018, the mortgage origination segment's MSR asset had a fair value of \$67.9 million. All income related to retained servicing, including changes in the value of the MSR asset, is included in noninterest income. Depending on the interest rate environment, it is possible that the fair value of our MSR asset may be reduced in the future. If such changes in fair value significantly reduce the carrying value of our MSR asset, our financial condition and results of operations would be negatively affected.

Changes in the method of determining LIBOR, or the replacement of LIBOR with an alternative reference rate, may adversely affect interest income or expense.



Certain loans we originate bear interest at a floating rate based on LIBOR. We also pay interest on certain notes and are counterparty to derivative agreements that are based on LIBOR.

As previously discussed, in July 2017, the FCA announced that it intends to cease compelling banks to submit rates for the calculation of LIBOR after 2021. The ARRC has proposed that SOFR is the rate that represents best practice as the alternative to LIBOR for use in derivatives and other financial contracts that are currently indexed to LIBOR. ARRC has proposed a paced market transition plan to SOFR from LIBOR, and organizations are currently working on industry-wide and company-specific transition plans as it relates to derivatives and cash markets exposed to LIBOR.

It is unclear whether, or in what form, LIBOR will continue to exist after 2021. Any transition to an alternative benchmark will require careful consideration and implementation so as not to disrupt the stability of financial markets. If LIBOR ceases to exist, we may need to take a variety of actions, including negotiating certain of our agreements based on an alternative benchmark that may be established, if any. There is no guarantee that a transition from LIBOR to an alternative benchmark will not result in financial market disruptions, significant changes in benchmark rates or adverse changes in the value of certain of our loans, and our income and expense.

Table of Contents

Income that we recognize in connection with the purchase discount of the credit-impaired loans acquired in the Bank Transactions and accounted for under Accounting Standards Codification 310-30 could be volatile in nature and have significant effects on reported net income.

In connection with the Bank Transactions, we acquired loans at an aggregate discount of \$540.5 million. The Bank Transactions have each been accounted for under the acquisition method of accounting. Accordingly, the respective discounts are amortized and accreted to interest income on a monthly basis. The effective yield and related discount accretion on credit-impaired loans is initially determined at the acquisition date based upon estimates of the timing and amount of future cash flows as well as the amount of credit losses that will be incurred. These estimates are updated quarterly. In future periods, if actual historical results combined with future projections of these factors (amount, timing, or credit losses) differ from the initial projections, the effective yield and the amount of discount recognized will change. Volatility may increase as the variance of actual results from initial projections increases. As the acquired loans are removed from our books, the related discount will no longer be available for accretion into income. Aggregate accretion of \$39.1 million on loans purchased at a discount in the Bank Transactions was recorded as interest income during 2018. As of December 31, 2018, the balance of our discount on loans in the aggregate was \$99.8 million.

We ultimately may write-off goodwill and other intangible assets resulting from business combinations.

As a result of purchase accounting in connection with acquisitions, our consolidated balance sheet at December 31, 2018, included goodwill of \$291.4 million and other intangible assets, net of accumulated amortization, of \$38.0 million. On an ongoing basis, we evaluate whether facts and circumstances indicate any impairment of value of intangible assets. As circumstances change, we may not realize the value of these intangible assets. If we determine that a material impairment has occurred, we will be required to write-off the impaired portion of intangible assets, which could have a material adverse effect on our results of operations in the period in which the write-off occurs.

Based on the results of our annual quantitative analysis as of October 1, 2018, the fair values of each of our reporting units indicated no impairment of goodwill. Any downward revisions to current year actual and future forecasted operating performance, in conjunction with any changes to long-term growth rates or discount rates, may cause the fair value of the respective reporting unit to decline. If the estimated fair value is less than the carrying value, we would be required to recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized would not exceed the total amount of goodwill allocated to that reporting unit.

The accuracy of our financial statements and related disclosures could be affected if we are exposed to actual conditions different from the judgments, assumptions or estimates used in our critical accounting policies.

The preparation of financial statements and related disclosure in conformity with GAAP requires us to make judgments, assumptions and estimates that affect the amounts reported in our consolidated financial statements and accompanying notes. Our critical accounting policies, which are included in this Annual Report, describe those significant accounting policies and methods used in the preparation of our consolidated financial statements that we consider “critical” because they require judgments, assumptions and estimates that materially impact our consolidated financial statements and related disclosures. As a result, if future events differ significantly from the judgments, assumptions and estimates in our critical accounting policies, such events or assumptions could have a material impact on our audited consolidated financial statements and related disclosures.

We are dependent on our management team, and the loss of our senior executive officers or other key employees could impair our relationship with customers and adversely affect our business and financial results.

Our success is dependent, to a large degree, upon the continued service and skills of our existing management team and other key employees with long-term customer relationships. Our business and growth strategies are built primarily upon our ability to retain employees with experience and business relationships within their respective segments. The loss of one or more of these key personnel could have an adverse impact on our business because of their skills, knowledge of the market, years of industry experience and the difficulty of finding qualified replacement personnel. In addition, we currently do not have non-competition agreements with certain members of management and other key employees. If any of these personnel were to leave and compete with us, our business, financial condition, results of operations and growth could suffer.

Table of Contents

A decline in the market for municipal advisory services could adversely affect our business and results of operations.

Our broker-dealer segment has historically earned a material portion of its revenues from advisory fees paid to it by its clients, in large part upon the successful completion of the client's transaction. New issuances in the municipal market by cities, counties, school districts, state and other governmental agencies, airports, healthcare institutions, institutions of higher education and other clients that the public finance department serves can be subject to significant fluctuations based on factors such as changes in interest rates, property tax bases, budget pressures on certain issuers caused by uncertain economic times and other factors. A decline in the market for municipal advisory services due to the factors listed above could have an adverse effect on our business and results of operations.

We are subject to losses due to fraudulent and negligent acts.

Our banking and mortgage origination businesses expose us to fraud risk from our loan and deposit customers and the parties they do business with, as well as from our employees, contractors and vendors. We rely heavily upon information supplied by third parties, including the information contained in credit applications, property appraisals, title information, equipment pricing and valuation, and employment and income documentation, in deciding which loans to originate and the terms of those loans. If any of the information upon which we rely is misrepresented, either fraudulently or negligently, and the misrepresentation is not detected prior to funding, the value of the collateral may be significantly lower than expected, the source of repayment may not exist or may be significantly impaired, or we may fund a loan that we would not have funded or on terms we would not have extended. While we have underwriting and operational controls in place to help detect and prevent such fraud, no such controls are effective to detect or prevent all fraud, and we have experienced losses resulting from fraud in the past. Whether a misrepresentation is made by the applicant, another third party or one of our own employees, we may bear the risk of loss associated with the misrepresentation. For example, during 2016, the Bank discovered irregularities with respect to a loan that was in default, including the genuineness of certain underlying documents that supported the loan and the operations of the borrower's business. As a result of the payment default and other irregularities, the Bank increased its provision for loan losses and recorded a \$24.5 million charge-off during the second quarter of 2016, representing the entire outstanding principal balance of the loan. A loan subject to a material misrepresentation is typically unsellable or subject to repurchase if it is sold prior to detection of the misrepresentation. We maintain fraud insurance, but this insurance may not be sufficient to cover all of our losses from any fraudulent acts.

Our broker-dealer and insurance underwriting activities also expose us to fraud risks. When acting as an underwriter, our broker-dealer segment may be liable jointly and severally under federal, state and foreign securities laws for false and misleading statements concerning the securities, or the issuer of the securities, that it underwrites. We are sometimes brought into lawsuits in connection with our correspondent clearing business based on actions of our correspondents. In addition, we may act as a fiduciary in other capacities that could expose us to liability under such laws or under common law fiduciary principles. Furthermore, our insurance segment's success also depends, in part, on its ability to detect and respond to fraudulent or inflated claims.

The soundness of other financial institutions could adversely affect our business.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty and other relationships. We have exposure to many different counterparties and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, credit unions, investment banks, mutual and hedge funds, and other institutional clients. As a result, defaults by, or even negative speculation about, one or more financial services institutions, or the financial services industry in general, have led to market-wide liquidity problems in the past and could lead to losses or defaults by us or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when we hold collateral that cannot be realized or is liquidated at prices not sufficient to recover the full amount of the receivable due to us. Any such losses could be material and could materially and adversely affect our business, financial condition, results of operations or cash flows.

Negative publicity regarding us, or financial institutions in general, could damage our reputation and adversely impact our business and results of operations.

Our ability to attract and retain customers and conduct our business could be adversely affected to the extent our reputation is damaged. Reputational risk, or the risk to our business, earnings and capital from negative public opinion

## Table of Contents

regarding our company, or financial institutions in general, is inherent in our business. Adverse perceptions concerning our reputation could lead to difficulties in generating and maintaining accounts as well as in financing them. In particular, such negative perceptions could lead to decreases in the level of deposits that consumer and commercial customers and potential customers choose to maintain with us. Negative public opinion could result from actual or alleged conduct in any number of activities or circumstances, including lending or foreclosure practices; sales practices; corporate governance and potential conflicts of interest; ethical failures or fraud, including alleged deceptive or unfair lending or pricing practices; regulatory compliance; protection of customer information; cyber-attacks, whether actual, threatened, or perceived; negative news about us or the financial institutions industry generally; general company performance; or actions taken by government regulators and community organizations in response to such activities or circumstances. Furthermore, our failure to address, or the perception that we have failed to address, these issues appropriately could impact our ability to keep and attract customers and/or employees and could expose us to litigation and/or regulatory action, which could have an adverse effect on our business and results of operations.

We face strong competition from other financial institutions and financial service and insurance companies, which may adversely affect our operations and financial condition.

Our banking segment primarily competes with national, regional and community banks within various markets where the Bank operates. The Bank also faces competition from many other types of financial institutions, including savings and loan associations, savings banks, finance companies and credit unions. A number of these banks and other financial institutions have substantially greater resources and lending limits, larger branch systems and a wider array of banking services than we do. We also compete with other providers of financial services, such as money market mutual funds, brokerage and investment banking firms, consumer finance companies, pension trusts, insurance companies and governmental organizations, each of which may offer more favorable financing than we are able to provide. In addition, some of our non-bank competitors are not subject to the same extensive regulations that govern us. The banking business in Texas has remained competitive over the past several years, and we expect the level of competition we face to further increase. Competition for deposits and in providing lending products and services to consumers and businesses in our market area is intense and pricing is important. Other factors encountered in competing for savings deposits are convenient office locations, interest rates and fee structures of products offered. Direct competition for savings deposits also comes from other commercial bank and thrift institutions, money market mutual funds and corporate and government securities that may offer more attractive rates than insured depository institutions are willing to pay. Competition for loans is based on factors such as interest rates, loan origination fees and the range of services offered by the provider. We seek to distinguish ourselves from our competitors through our commitment to personalized customer service and responsiveness to customer needs while providing a range of competitive loan and deposit products and other services. Our profitability depends on our ability to compete effectively in these markets. This competition may reduce or limit our margins on banking services, reduce our market share and adversely affect our results of operations and financial condition.

The financial advisory and investment banking industries also are intensely competitive industries and will likely remain competitive. Our broker-dealer business competes directly with numerous other financial advisory and investment banking firms, broker-dealers and banks, including large national and major regional firms and smaller niche companies, some of whom are not broker-dealers and, therefore, not subject to the broker-dealer regulatory framework. In addition to competition from firms currently in the industry, there has been increasing competition

from others offering financial services, including automated trading and other services based on technological innovations. Our broker-dealer business competes on the basis of a number of factors, including the quality of advice and service, technology, product selection, innovation, reputation, client relationships and price. Increased pressure created by any current or future competitors, or by competitors of our broker-dealer business collectively, could materially and adversely affect our business and results of operations. Increased competition may result in reduced revenue and loss of market share. Further, as a strategic response to changes in the competitive environment, our broker-dealer business may from time to time make certain pricing, service or marketing decisions that also could materially and adversely affect our business and results of operations.

Our mortgage origination business faces vigorous competition from banks and other financial institutions, including large financial institutions as well as independent mortgage banking companies, commercial banks, savings banks and savings and loan associations. Our mortgage origination segment competes on a number of factors including customer service, quality and range of products and services offered, price, reputation, interest rates, closing process and duration, and loan origination fees. The ability to attract and retain skilled mortgage origination professionals is critical to our mortgage origination business. We seek to distinguish ourselves from our competitors through our commitment to personalized customer service and responsiveness to customer needs while providing a range of competitive mortgage loan products and services.

Table of Contents

The insurance industry also is highly competitive and has, historically, been characterized by periods of significant price competition, alternating with periods of greater pricing discipline during which competitors focus on other factors, including service, experience, the strength of agent and policyholder relationships, reputation, speed and accuracy of claims payment, perceived financial strength, ratings, scope of business, commissions paid and policy and contract terms and conditions. Our insurance business competes with many other insurers, including large national companies that have greater financial, marketing and management resources than our insurance segment. Many of these competitors also have better ratings and market recognition than our insurance business.

In addition, industry developments also could increase competition in our insurance segment's industry. These developments include changes in practices and other effects caused by the Internet (including direct marketing campaigns by our insurance segment's competitors in established and new geographic markets), which have led to greater competition in the insurance business and increased expectations for customer service. These developments could prevent our insurance business from expanding its book of business. Our insurance business also faces competition from new entrants into the insurance market. New entrants do not have historic claims or losses to address and, therefore, may be able to price policies on a basis that is not favorable to our insurance business. New competition could reduce the demand for our insurance segment's insurance products, which could have a material adverse effect on our financial condition and results of operations.

Overall, competition among providers of financial products and services continues to increase as technological advances have lowered the barriers to entry for financial technology companies, with consumers having the opportunity to select from a growing variety of traditional and nontraditional alternatives, including online checking, savings and brokerage accounts, online lending, online insurance underwriters, crowdfunding, digital wallets, and money transfer services. The ability of non-banking financial institutions to provide services previously limited to commercial banks has intensified competition. Because non-banking financial institutions are not subject to many of the same regulatory restrictions as banks and bank holding companies, they can often operate with greater flexibility and lower cost structures. This competition could result in the loss of customer deposits and brokerage accounts, lower mortgage originations and lower insurance premiums written which could have a material adverse affect on our financial condition and results of operations.

If the actual losses and loss adjustment expenses of our insurance segment exceed its loss and expense estimates, its financial condition and results of operations could be materially adversely affected.

The financial condition and results of operations of our insurance segment depend upon its ability to assess accurately the potential losses associated with the risks that it insures. Our insurance segment establishes reserve liabilities to cover the payment of all losses and LAE incurred under the policies that it writes. These liability estimates include case estimates, which are established for specific claims that have been reported to our insurance segment, and liabilities for claims that have been incurred but not reported ("IBNR"). LAE represent expenses incurred to investigate and settle claims. To the extent that losses and LAE exceed estimates, NLIC and ASIC will be required to increase their reserve liabilities and reduce their income in the period in which the deficiency is identified. In addition,



increasing reserves causes a reduction in policyholders' surplus and could cause a downgrade in the ratings of NLIC and ASIC. This, in turn, could diminish our ability to sell insurance policies.

The liability estimation process for our insurance segment's casualty insurance coverage possesses characteristics that make case and IBNR reserving inherently less susceptible to accurate actuarial estimation than is the case with property coverages. Unlike property losses, casualty losses are claims made by third-parties of which the policyholder may not be aware and, therefore, may be reported a significant time after the occurrence, including sometimes years later. As casualty claims most often involve claims of bodily injury, assessment of the proper case estimates is a far more subjective process than claims involving property damage. In addition, in determining the case estimate for a casualty claim, information develops slowly over the life of the claim and can subject the case estimation to substantial modification well after the claim was first reported. Numerous factors impact the casualty case reserving process, such as venue, the amount of monetary damage, legislative activity, the permanence of the injury and the age of the claimant.

The effects of inflation could cause the severity of claims from catastrophes or other events to rise in the future. Increases in the values and geographic concentrations of policyholder property and the effects of inflation have resulted in increased severity of industry losses in recent years, and our insurance segment expects that these factors will increase the severity of losses in the future. The severity of some catastrophic weather events, including the scope and extent of damage and the inability to gain access to damaged properties, and the ensuing shortages of labor and materials and resulting demand

Table of Contents

surge, provide additional challenges to estimating ultimate losses. Our insurance segment's liabilities for losses and LAE include assumptions about future payments for settlement of claims and claims handling expenses, such as medical treatments and litigation costs. To the extent inflation causes these costs to increase above liabilities established for these costs, our insurance segment expects to be required to increase its liabilities, together with a corresponding reduction in its net income in the period in which the deficiency is identified.

Estimating an appropriate level of liabilities for losses and LAE is an inherently uncertain process. Accordingly, actual loss and LAE paid will likely deviate, perhaps substantially, from the liability estimates reflected in our insurance segment's consolidated financial statements. Claims could exceed our insurance segment's estimate for liabilities for losses and LAE, which could have a material adverse effect on its financial condition and results of operations.

If our insurance segment cannot obtain adequate reinsurance protection for the risks it underwrites or its reinsurers do not pay losses in a timely fashion, or at all, our insurance segment will suffer greater losses from these risks or may reduce the amount of business it underwrites, which may materially adversely affect its financial condition and results of operations.

Our insurance segment purchases reinsurance to protect itself from certain risks and to share certain risks it underwrites. During 2018, our insurance segment's personal lines ceded 6.8% of its direct insurance premiums written (primarily through excess of loss, quota share and catastrophe reinsurance treaties) and its commercial lines ceded 1.5% of its direct insurance premiums written (primarily through excess of loss and catastrophe reinsurance treaties). The total cost of reinsurance, inclusive of per risk excess and catastrophe, decreased 1.3% during 2018, compared with 2017, which was primarily attributable to reinstatement premiums associated with Hurricane Harvey, offset by lower premium rates. Reinsurance cost generally fluctuates as a result of storm costs or any changes in capacity within the reinsurance market.

From time to time, market conditions have limited, and in some cases have prevented, insurers from obtaining the types and amounts of reinsurance that they have considered adequate for their business needs. Accordingly, our insurance segment may not be able to obtain desired amounts of reinsurance. Even if our insurance segment is able to obtain adequate reinsurance, it may not be able to obtain it from entities with satisfactory creditworthiness or negotiate terms that it deems appropriate or acceptable. Although the cost of reinsurance is, in some cases, reflected in our insurance segment's premium rates, our insurance segment may have guaranteed certain premium rates to its policyholders. Under these circumstances, if the cost of reinsurance were to increase with respect to policies for which our insurance segment guaranteed the rates, our insurance segment would be adversely affected. In addition, if our insurance segment cannot obtain adequate reinsurance protection for the risks it underwrites, it may be exposed to greater losses from these risks or it may be forced to reduce the amount of business that it underwrites for such risks, which will reduce our insurance segment's revenue and may have a material adverse effect on its results of operations and financial condition.

At December 31, 2018, our insurance segment had \$5.4 million in reinsurance recoverables and receivables, including ceded paid loss recoverables, ceded losses and LAE recoverables and ceded unearned insurance premiums. Our insurance segment expects to continue to purchase substantial reinsurance coverage in the foreseeable future. Because our insurance segment remains primarily liable to its policyholders for the payment of their claims, regardless of the reinsurance it has purchased relating to those claims, in the event that one of its reinsurers becomes insolvent or otherwise refuses to reimburse our insurance segment for losses paid, or delays reimbursing our insurance segment for losses paid, its liability for these claims could materially and adversely affect its financial condition and results of operations.

If the states in which our insurance segment writes insurance increase the assessments that insurance companies are required to pay, our insurance segment's financial condition and results of operations will suffer.

NLIC and ASIC are subject to a variety of taxes, fines, levies, license fees, tariffs and other assessments that may, from time to time, be material. These assessments are made by the states in which NLIC and ASIC operate and include participation in residual market or involuntary risk plans in various states that provide insurance coverage to individuals or entities that otherwise are unable to purchase such coverage from private insurers. These plans include

the Georgia Underwriting Association, Texas FAIR Plan Association, Texas Windstorm Insurance Agency, the Louisiana Citizens Property Insurance Corporation, the Mississippi Residential Property Insurance Underwriting Association and the Mississippi Windstorm Underwriting Association. If these plans experience losses in excess of their capitalization, they may assess participating insurers, including NLIC and ASIC, for proportionate shares of their financial deficit. For example, to address a 2016 deficit and losses resulting from Hurricane Harvey in 2017, the Texas FAIR Plan Association levied an assessment on participating companies totaling \$64.6 million, of which NLC's insurance subsidiaries' share was \$0.6 million. In addition, the Texas Windstorm Insurance Agency levied an assessment on participating companies

## Table of Contents

totaling \$175.0 million, of which NLC's insurance subsidiaries' share was \$1.6 million. The ultimate impact hurricanes have on state facilities cannot be predicted and future assessments can occur whenever the involuntary facilities experience financial deficits.

NLIC and ASIC are also subject to assessments in the states in which they write insurance for various purposes, including the provision of funds necessary to fund the operations of various insurance guaranty associations, which pay covered claims under certain policies issued by impaired, insolvent or failed insurance companies. These assessments are generally set based on an insurer's percentage of the total premiums written in the relevant state within a particular line of business for the relevant time period. For the years ended December 31, 2018, 2017 and 2016, our insurance segment paid no assessments. We cannot, however, predict with certainty the amount of future assessments, because these assessments depend on factors outside our control, such as the insolvencies of other insurance companies, the market shares of other insurance companies writing in a particular state and the degree to which other companies write in coastal areas.

We are subject to legal claims and litigation, including potential securities law liabilities, any of which could have a material adverse effect on our business.

We face significant legal risks in each of the business segments in which we operate, and the volume of legal claims and amount of damages and penalties claimed in litigation and regulatory proceedings against financial service companies remains high. These risks often are difficult to assess or quantify, and their existence and magnitude often remain unknown for substantial periods of time. Substantial legal liability or significant regulatory action against us or any of our subsidiaries could have a material adverse effect on our results of operations or cause significant reputational harm to us, which could seriously harm our business and prospects. Further, regulatory inquiries and subpoenas, other requests for information, or testimony in connection with litigation may require incurrence of significant expenses, including fees for legal representation and fees associated with document production. These costs may be incurred even if we are not a target of the inquiry or a party to the litigation. Any financial liability or reputational damage could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Further, in the normal course of business, our broker-dealer segment has been subject to claims by customers and clients alleging unauthorized trading, churning, mismanagement, suitability of investments, breach of fiduciary duty or other alleged misconduct by our employees or brokers. We are sometimes brought into lawsuits based on allegations concerning our correspondents. As underwriters, we are subject to substantial potential liability for material misstatements and omissions in prospectuses and other communications with respect to underwritten offerings of securities. Prolonged litigation producing significant legal expenses or a substantial settlement or adverse judgment could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Because we may use a substantial portion of our remaining excess capital to make acquisitions or effect a business combination, we may become subject to risks inherent in pursuing and completing any such acquisitions or business

combination.

We may make acquisitions or effect business combinations with a substantial portion of our remaining excess capital. We may not, however, be able to identify suitable targets, consummate acquisitions or effect a combination on commercially acceptable terms or, if consummated, successfully integrate personnel and operations.

The success of any acquisition or business combination will depend upon, among other things, the ability of management and our employees to integrate personnel, operations, products and technologies effectively, to attract, retain and motivate key personnel and to retain customers and clients of targets. It is possible that the integration process could result in the loss of key employees, the disruption of ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with clients, customers, depositors and employees. In addition, the integration of certain operations will require the dedication of significant management resources, which may temporarily distract management's attention from our day-to-day business. Any inability to realize the full extent, or any, of the anticipated cost savings and financial benefits of any acquisitions we make, as well as any delays encountered in the integration process, could have an adverse effect on our business and results of operations, which could adversely affect our financial condition and cause a decrease in our earnings per share or decrease or delay the expected accretive effect of the acquisitions and contribute to a decrease in the price of our common stock. In addition, any acquisition or business combination we undertake may consume available cash resources, result in potentially dilutive issuances of equity securities and divert management's attention from other business concerns. Even if we conduct extensive due diligence on a target business that we acquire or with which we merge, our diligence may not surface all material issues

Table of Contents

that may adversely affect a particular target business, and we may be forced to later write-down or write-off assets, restructure our operations or incur impairment or other charges that could result in our reporting losses. Consequently, we also may need to make further investments to support the acquired or combined company and may have difficulty identifying and acquiring the appropriate resources.

We may enter, through acquisitions or a business combination, into new lines of business or initiate new service offerings subject to the restrictions imposed upon us as a regulated financial holding company. Accordingly, there is no basis for you to evaluate the possible merits or risks of the particular target business with which we may combine or that we may ultimately acquire.

Subject to the restrictions imposed upon us as a regulated financial holding company, we may also use excess capital to make investments in companies engaged in non-financial activities. These investments could decline in value and are likely to be substantially less liquid than exchange-listed securities, if we are able to sell them at all. If we are required to sell these investments quickly, we may receive significantly less value than if we could have otherwise have sold them. Losses on these investments could have an adverse impact on our profitability, results of operations and financial condition.

We may be subject to environmental liabilities in connection with the foreclosure on real estate assets securing the loan portfolio of our banking segment.

Hazardous or toxic substances or other environmental hazards may be located on the real estate that secures our loans. If we acquire such properties as a result of foreclosure, or otherwise, we could become subject to various environmental liabilities. For example, we could be held liable for the cost of cleaning up or otherwise addressing contamination at or from these properties. We could also be held liable to a governmental entity or third party for property damage, personal injury or other claims relating to any environmental contamination at or from these properties. In addition, we could be held liable for costs relating to environmental contamination at or from our current or former properties. We may not detect all environmental hazards associated with these properties. If we ever became subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be harmed.

If we fail to maintain an effective system of internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

Effective internal controls are necessary for us to provide timely and reliable financial reports and effectively prevent fraud. Any inability to provide reliable financial reports or prevent fraud could harm our business. If we fail to maintain adequate internal controls, our financial statements may not accurately reflect our financial condition. Inadequate internal control over financial reporting could impact the reliability and timeliness of our financial reports

and could cause investors to lose confidence in our reported financial information, which could have a negative effect on our business and the value of our securities.

The debt agreements of our insurance segment and its controlled affiliates contain financial covenants and impose restrictions on its business.

The surplus indentures governing NLIC's two LIBOR plus 4.10% and 4.05% notes due May and September 2033, respectively, and ASIC's LIBOR plus 4.05% notes due April 2034 contain restrictions on the ability to, among other things, declare and pay dividends and merge or consolidate. In addition, NLC has other credit arrangements with its affiliates and other third-parties.

NLC's ability to comply with these covenants may be affected by events beyond its control, including prevailing economic, financial and industry conditions. The breach of any of these covenants could result in a default under the loan agreements or indentures governing the notes or under its other debt agreements. An event of default under its debt agreements would permit some of its lenders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. If NLC were unable to repay debt to its secured lenders, these lenders could proceed against the collateral securing that debt. In addition, acceleration of its other indebtedness may cause NLC to be unable to make interest payments on the notes. Other agreements that NLC or its insurance company subsidiaries may enter into in the future may contain covenants imposing significant restrictions on their respective businesses that are similar to, or in addition to, the covenants under their respective existing agreements. These restrictions may affect NLC's ability to operate its business and may limit its ability to take advantage of potential business opportunities as they arise.

Table of Contents

Risks Related to Our Common Stock

We may issue shares of preferred stock or additional shares of common stock to complete an acquisition or effect a combination or under an employee incentive plan after consummation of an acquisition or business combination, which would dilute the interests of our stockholders and likely present other risks.

The issuance of shares of preferred stock or additional shares of common stock:

- may significantly dilute the equity interest of our stockholders;
- may subordinate the rights of holders of common stock if preferred stock is issued with rights senior to those afforded our common stock;
- could cause a change in control if a substantial number of shares of common stock are issued, which may affect, among other things, our ability to use our net operating loss carry forwards; and
- may adversely affect prevailing market prices for our common stock.

Our board of directors, in its sole discretion, may designate and issue one or more series of preferred stock from the authorized and unissued shares of preferred stock. Subject to limitations imposed by law or our articles of incorporation, our board of directors is empowered to determine the designation and number of shares constituting each series of preferred stock, as well as any designations, qualifications, privileges, limitations, restrictions or special or relative rights of additional series. The rights of preferred stockholders may supersede the rights of common stockholders. Preferred stock could be issued with voting and conversion rights that could adversely affect the voting power of the shares of our common stock. The issuance of preferred stock could also result in a series of securities outstanding that would have preferences over the common stock with respect to dividends and in liquidation.

Our common stock price may experience substantial volatility, which may affect your ability to sell our common stock at an advantageous price.

Price volatility of our common stock may affect your ability to sell our common stock at an advantageous price. Market price fluctuations in our common stock may arise due to acquisitions, dispositions or other material public announcements, including those regarding dividends or changes in management, along with a variety of additional factors, including, without limitation, other risks identified in “Forward-looking Statements” and these “Risk Factors.” In addition, the stock markets in general, including the NYSE, have experienced extreme price and trading fluctuations. These fluctuations have resulted in volatility in the market prices of securities that often have been unrelated or disproportionate to changes in operating performance. These broad market fluctuations may adversely affect the market price of our common stock.



Existing circumstances may result in several of our directors having interests that may conflict with our interests.

A director who has a conflict of interest with respect to an issue presented to our board will have no inherent legal obligation to abstain from voting upon that issue. We do not have provisions in our bylaws or charter that require an interested director to abstain from voting upon an issue, and we do not expect to add provisions in our charter and bylaws to this effect. Although each director has a duty to act in good faith and in a manner he or she reasonably believes to be in our best interests, there is a risk that, should interested directors vote upon an issue in which they or one of their affiliates has an interest, their vote may reflect a bias that could be contrary to our best interests. In addition, even if an interested director abstains from voting, the director's participation in the meeting and discussion of an issue in which he or she has, or companies with which he or she is associated have, an interest could influence the votes of other directors regarding the issue.

Our rights and the rights of our stockholders to take action against our directors and officers are limited.

We are organized under Maryland law, which provides that a director or officer has no liability in that capacity if he or she performs his or her duties in good faith, in a manner he or she reasonably believes to be in our best interests and with the care that an ordinarily prudent person in a like position would use under similar circumstances. In addition, our charter eliminates our directors' and officers' liability to us and our stockholders for money damages, except for liability resulting from actual receipt of an improper benefit or profit in money, property or services or active and deliberate dishonesty established by a final judgment and that is material to the cause of action. Our bylaws require us to indemnify our directors and officers for liability resulting from actions taken by them in those capacities to the maximum extent

Table of Contents

permitted by Maryland law. As a result, our stockholders and we may have more limited rights against our directors and officers than might otherwise exist under common law. In addition, we may be obligated to fund the defense costs incurred by our directors and officers.

Our charter and bylaws contain provisions that could discourage acquisition bids or merger proposals, which may adversely affect the market price of our common stock.

**Authority to Issue Additional Shares.** Under our charter, our board of directors may issue up to an aggregate of ten million shares of preferred stock without stockholder action. The preferred stock may be issued, in one or more series, with the preferences and other terms designated by our board of directors that may delay or prevent a change in control of us, even if the change is in the best interests of stockholders. At December 31, 2018, no shares of preferred stock were outstanding.

**Banking Laws.** Any change in control of our company is subject to prior regulatory approval under the Bank Holding Company Act or the Change in Bank Control Act, which may delay, discourage or prevent an attempted acquisition or change in control of us.

**Insurance Laws.** NLIC and ASIC are domiciled in the State of Texas. Before a person can acquire control of an insurance company domiciled in Texas, prior written approval must be obtained from the TDI. Acquisition of control would be presumed on the acquisition, directly or indirectly, of ten percent or more of our outstanding voting stock, unless the regulators determine otherwise. Prior to granting approval of an application to acquire control of a domestic insurer, the TDI will consider several factors, such as:

- the financial strength of the acquirer;
  - the integrity and management experience of the acquirer's board of directors and executive officers;
- the acquirer's plans for the management of the insurer;
- the acquirer's plans to declare dividends, sell assets or incur debt;
- the acquirer's plans for the future operations of the domestic insurer;
- the impact of the acquisition on continued licensure of the domestic insurer;
- the impact on the interests of Texas policyholders; and
- any anti-competitive results that may arise from the consummation of the acquisition of control.

These laws may discourage potential acquisition proposals for us and may delay, deter or prevent a change of control of us, including transactions that some or all of our stockholders might consider desirable.

FINRA. Any change in control (as defined under FINRA rules) of any of the Hilltop Broker-Dealers, including through acquisition, is subject to prior regulatory approval by FINRA which may delay, discourage or prevent an attempted acquisition or other change in control of such broker-dealers.

Restrictions on Calling Special Meeting, Cumulative Voting and Director Removal. Our bylaws include a provision prohibiting holders that do not or have not owned, continuously for at least one year as of the record date of such proposed meeting, capital stock representing at least 15% of the shares entitled to be voted at such proposed meeting, from calling a special meeting of stockholders. Our charter does not provide for the cumulative voting in the election of directors. In addition, our charter provides that our directors may only be removed for cause and then only by an affirmative vote of at least two-thirds of the votes entitled to be cast in the election of directors. Any amendment to our charter relating to the removal of directors requires the affirmative vote of two-thirds of all of the votes entitled to be cast on the matter. These provisions of our bylaws and charter may delay, discourage or prevent an attempted acquisition or change in control of us.

There can be no assurance that we will continue to declare cash dividends or repurchase stock.

In October 2016, we announced that our board of directors authorized a dividend program under which we intend to pay quarterly dividends on our common stock, subject to quarterly declarations by our board of directors. During 2018, we declared and paid cash dividends of \$0.28 per common share. In January 2018, our board of directors reauthorized the

Table of Contents

stock repurchase program, under which it authorized us to repurchase, in the aggregate, up to \$50.0 million of our outstanding common stock through January 2019. In July 2018, our board of directors increased the aggregate amount of common stock that we may repurchase under this program to \$100.0 million. During 2018, we paid \$59.0 million to repurchase an aggregate of 2,729,568 shares of our common stock at an average price of \$21.61 per share. In January 2019, our board of directors authorized a new stock repurchase program through January 2020, pursuant to which we are authorized to repurchase, in the aggregate, up to \$50.0 million of our outstanding common stock, inclusive of repurchases to offset dilution related to grants of stock-based compensation.

Any future declarations, amount and timing of any dividends and/or the amount and timing of such stock repurchases are subject to capital availability and the discretion of our board of directors, which must evaluate, among other things, whether cash dividends and/or stock repurchases are in the best interest of our stockholders and are in compliance with all applicable laws and any agreements containing provisions that limit our ability to declare and pay cash dividends and/or repurchase stock. Our ability to pay dividends and/or repurchase stock will depend upon, among other factors, our cash balances and potential future capital requirements for strategic transactions, including acquisitions, the ability of our subsidiaries to pay dividends to Hilltop, capital adequacy requirements and other regulatory restrictions on us and our subsidiaries, policies of the Federal Reserve Board, equity and debt service requirements senior to our common stock, earnings, financial condition, the general economic and regulatory climate and other factors beyond our control that our board of directors may deem relevant. In addition, the amount we spend and the number of shares we are able to repurchase under our stock repurchase program may further be affected by a number of other factors, including the stock price and blackout periods in which we are restricted from repurchasing shares. Our dividend payments and/or stock repurchases may change from time to time, and we cannot provide assurance that we will continue to declare dividends and/or repurchase stock in any particular amounts or at all. A reduction in or elimination of our dividend payments, our dividend program and/or stock repurchases could have a negative effect on our stock price.

An investment in our common stock is not an insured deposit.

An investment in our common stock is not a bank deposit and is not insured or guaranteed by the FDIC, SIPC, the TDI or any other government agency. Accordingly, you should be capable of affording the loss of any investment in our common stock.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

We lease office space through PCC for our principal executive offices in Dallas, Texas. In addition to our principal office, our various business segments conduct business at various locations. We have options to renew leases at most locations that we do not own.

During 2018, we also made an investment in land and a mixed-use real estate development in the City of University Park, Texas, which is expected to serve as headquarters for both Hilltop and the Bank beginning in the fourth quarter of 2019.

**Banking.** At December 31, 2018, our banking segment conducted business at 72 locations throughout Texas, including seven support facilities. We lease 36 banking locations, including our principal offices, and we own the remaining 36 banking locations.

**Broker-Dealer.** At December 31, 2018, our broker-dealer segment conducted business from 53 locations in 20 states. Each of these locations is leased by Hilltop Securities.

**Mortgage Origination.** At December 31, 2018, our mortgage origination segment conducted business from over 300 locations in 44 states. Each of these locations is leased by PrimeLending.

**Insurance.** At December 31, 2018, our insurance segment leases office space for its corporate, claims and customer service operations. Our insurance segment's principal office is leased from an affiliate, Hilltop Securities.

Table of Contents

Item 3. Legal Proceedings.

For a description of material pending legal proceedings, see the discussion set forth under the heading “Legal Matters” in Note 18 to our Consolidated Financial Statements, which is incorporated by reference herein.

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Securities, Stockholder and Dividend Information

Our common stock is listed on the New York Stock Exchange under the symbol “HTH”. At February 14, 2019, there were 93,611,624 shares of our common stock outstanding with 442 stockholders of record.

In October 2016, we announced that our board of directors authorized a dividend program under which we pay quarterly dividends on our common stock, subject to quarterly declarations by our board of directors. During 2018, we declared and paid cash dividends of \$0.28 per common share. On January 24, 2019, we announced that our board of directors increased our quarterly dividend to \$0.08 per common share. Although we expect to continue to pay dividends, we may elect not to pay dividends. Any declarations of dividends, and the amount and timing thereof, will be at the discretion of our board of directors, which must evaluate, among other things, whether cash dividends are in the best interest of our stockholders and are in compliance with all applicable laws and any agreements containing provisions that limit our ability to declare and pay cash dividends. Our ability to pay dividends will depend upon, among other factors, our cash balances and potential future capital requirements for strategic transactions, including acquisitions, equity and debt service requirements senior to our common stock, earnings, financial condition, the general economic and regulatory climate and other factors beyond our control that our board of directors may deem relevant. Our dividend payments may change from time to time, and we cannot provide assurance that we will continue to declare dividends in any particular amounts or at all. A reduction in or elimination of our dividend payments and/or our dividend program could have a negative effect on our stock price. See Item 1A, “Risk Factors — Risks Related to our Business — There can be no assurance that we will continue to declare cash dividends or repurchase stock.”

## Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth information at December 31, 2018 with respect to compensation plans under which shares of our common stock may be issued. Additional information concerning our stock-based compensation plans is presented in Note 20, Stock-Based Compensation, in the notes to our consolidated financial statements.

## Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in first column)
Equity compensation plans approved by security holders*	—	\$ —	1,246,880
Total	—	\$ —	1,246,880

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\*In September 2012, our stockholders approved the Hilltop Holdings Inc. 2012 Equity Incentive Plan (the “2012 Plan”), which allows for the granting of nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance awards, dividend equivalent rights and other awards to employees of Hilltop, its subsidiaries and outside directors of Hilltop. In the aggregate, 4,000,000 shares of common stock may be delivered pursuant to awards granted under the 2012 Plan. At December 31, 2018, 3,128,011 awards had been granted pursuant to the 2012 Plan, while 374,891 awards were forfeited and are eligible for reissuance. All shares outstanding under the 2012 Plan, whether vested or unvested, are entitled to receive dividends and to vote, unless forfeited. No participant in our 2012 Plan may be granted awards in any fiscal year covering more than 1,250,000 shares of our common stock.

Table of Contents

## Issuer Repurchases of Equity Securities

The following table details our repurchases of shares of common stock during the three months ended December 31, 2018.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1)
October 1 - October 31, 2018	60,000	\$ 19.85	60,000	\$ 59,977,931
November 1 - November 30, 2018	966,872	19.60	966,872	41,026,749
December 1 - December 31, 2018	—	—	—	41,026,749
Total	1,026,872	\$ 19.62	1,026,872	

(1) On January 25, 2018, we announced that our board of directors authorized a stock repurchase program under which we may repurchase, in the aggregate, up to \$50.0 million of our outstanding common stock through January 2019. In July 2018, our board of directors increased the aggregate amount of common stock that we may repurchase under this program to \$100.0 million, which is inclusive of repurchases to offset dilution related to grants of stock-based compensation. As of December 31, 2018, we had repurchased an aggregate of \$59.0 million of our outstanding common stock under this stock repurchase program.

## Recent Sales of Unregistered Securities

On December 31, 2018, we issued an aggregate of 8,131 shares of common stock under the 2012 Plan to certain non-employee directors as compensation for their service on our board of directors during the fourth quarter of 2018. The shares were issued pursuant to the exemption from registration under Section 4(a)(2) of the Securities Act.



Table of Contents

## Item 6. Selected Financial Data.

Our historical consolidated balance sheet data at December 31, 2018 and 2017 and our consolidated statement of operations data for the years ended December 31, 2018, 2017 and 2016 have been derived from our historical consolidated financial statements included elsewhere in this Annual Report. The following table shows our selected historical financial data for the periods indicated. You should read our selected historical financial data, together with the notes thereto, in conjunction with the more detailed information contained in our consolidated financial statements and related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in this Annual Report. The operations acquired in the SWS Merger and BORO Acquisition are included in our operating results beginning January 1, 2015, and August 1, 2018, respectively (dollars in thousands, except per share data and weighted average shares outstanding).

	2018	2017	2016	2015	2014
Statement of Operations Data:					
Total interest income	\$ 579,428	\$ 507,156	\$ 455,954	\$ 469,838	\$ 388,769
Total interest expense	143,104	85,408	58,423	61,255	27,628
Net interest income	436,324	421,748	397,531	408,583	361,141
Provision for loan losses	5,088	14,271	40,620	12,715	16,933
Net interest income after provision for loan losses	431,236	407,477	356,911	395,868	344,208
Total noninterest income	1,022,790	1,205,064	1,286,965	1,227,642	799,311
Total noninterest expense	1,293,249	1,369,255	1,412,471	1,340,016	965,353
Income before income taxes	160,777	243,286	231,405	283,494	178,166
Income tax expense	35,050	110,142	83,461	70,915	65,608
Net income	125,727	133,144	147,944	212,579	112,558
Less: Net income attributable to noncontrolling interest	4,286	600	2,050	1,606	908
Income attributable to Hilltop	121,441	132,544	145,894	210,973	111,650
Dividends on preferred stock (1)	—	—	—	1,854	5,703
Income applicable to Hilltop common stockholders	\$ 121,441	\$ 132,544	\$ 145,894	\$ 209,119	\$ 105,947

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Per Share Data:

Earnings per common share - basic	\$ 1.28		\$ 1.36		\$ 1.48		\$ 2.10		\$ 1.18	
Weighted average shares outstanding - basic	94,969		97,137		98,404		99,074		89,710	
Earnings per common share - diluted	\$ 1.28		\$ 1.36		\$ 1.48		\$ 2.09		\$ 1.17	
Weighted average shares outstanding - diluted	95,067		97,353		98,629		99,962		90,573	
Book value per common share	\$ 20.83		\$ 19.92		\$ 18.98		\$ 17.56		\$ 14.93	
Tangible book value per common share	\$ 17.31		\$ 16.92		\$ 15.97		\$ 14.46		\$ 11.47	
Cash dividends declared per common share	\$ 0.28		\$ 0.24		\$ 0.06		\$ —		\$ —	
Dividend payout ratio (2)	21.90	%	17.59	%	4.05	%	—	%	—	%

Balance Sheet Data:

Total assets	\$ 13,683,572		\$ 13,365,786		\$ 12,738,062		\$ 11,867,001		\$ 9,242,416
Cash and due from banks	644,073		486,977		669,357		652,036		782,473
Securities	1,991,815		1,852,094		1,215,372		1,219,874		1,109,461
Investment in SWS common stock	—		—		—		—		70,282
Loans held for sale	1,393,246		1,715,357		1,795,463		1,533,678		1,309,693
Loans held for investment, net of unearned income (3)	6,930,458		6,455,798		6,099,626		5,587,911		4,563,116
Allowance for loan losses (3)	(59,486)		(63,686)		(54,599)		(46,947)		(41,652)
Goodwill and other intangible assets, net	329,440		288,240		296,503		306,676		311,591
Total deposits	8,536,156		7,978,119		7,063,811		6,952,683		6,369,892
Notes payable	228,872		208,809		317,912		238,716		56,684
Junior subordinated debentures	67,012		67,012		67,012		67,012		67,012
Total stockholders' equity	1,973,893		1,914,807		1,874,520		1,738,125		1,461,239

Performance Ratios

(4):										
Return on average stockholders' equity (5)	6.33	%	7.00	%	8.13	%	12.32	%	8.01	%
	0.93	%	1.03	%	1.21	%	1.70	%	1.26	%

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Return on average assets (5)										
Net interest margin (6)	3.55	%	3.61	%	3.68	%	3.71	%	4.71	%
Net interest margin (taxable equivalent) (7)	3.56	%	3.63	%	3.71	%	3.74	%	4.74	%
Asset Quality Ratios (4):										
Total nonperforming assets to total loans and other real estate	0.89	%	1.33	%	1.39	%	2.34	%	4.14	%
Allowance for loan losses to nonperforming loans	175.22	%	139.58	%	193.05	%	137.99	%	74.01	%
Allowance for loan losses to total loans	0.86	%	0.99	%	0.90	%	0.84	%	0.91	%
Net charge-offs to average loans outstanding	0.14	%	0.08	%	0.57	%	0.14	%	0.21	%
Capital Ratios:										
Equity to assets ratio	14.25	%	14.31	%	14.68	%	14.64	%	15.80	%
Tangible common equity to tangible assets	12.13	%	12.42	%	12.65	%	12.37	%	11.59	%

Table of Contents

	2018		2017		2016		2015		2014	
Regulatory Capital Ratios:										
Hilltop - Leverage ratio	12.53	%	12.94	%	13.51	%	12.65	%	14.17	%
Hilltop - Common equity Tier 1 risk-based capital ratio (8)	16.58	%	17.71	%	18.30	%				
Hilltop - Tier 1 risk-based capital ratio	17.04	%	18.24	%	18.87	%	18.48	%	19.02	%
Hilltop - Total risk-based capital ratio	17.47	%	18.78	%	19.34	%	18.89	%	19.69	%
PlainsCapital - Leverage ratio	12.47	%	12.32	%	12.35	%	13.22	%	10.31	%
PlainsCapital - Common equity Tier 1 risk-based capital ratio (8)	13.90	%	14.47	%	14.64	%				
PlainsCapital - Tier 1 risk-based capital ratio	13.90	%	14.47	%	14.64	%	16.25	%	13.74	%
PlainsCapital - Total risk-based capital ratio	14.63	%	15.29	%	15.38	%	16.99	%	14.45	%
Other Data:										
Banking Segment:										
Efficiency ratio (9)	61.93	%	58.24	%	58.87	%	56.45	%	61.17	%
Return on average assets (5)	1.23	%	0.85	%	0.94	%	1.36	%	1.20	%
Net interest margin (6)	4.23	%	4.31	%	4.65	%	5.05	%	4.97	%
Net interest margin (taxable equivalent) (7)	4.24	%	4.33	%	4.68	%	5.08	%	5.00	%
Broker-Dealer Segment:										
Net revenue (10)	\$ 352,592		\$ 412,156		\$ 416,938		\$ 367,466		\$ 131,595	
Compensation as a % of net revenue	62.0	%	60.8	%	60.6	%	69.6	%	59.7	%
Mortgage Origination Segment:										
	\$ 11,798,804		\$ 11,974,571		\$ 11,276,378		\$ 9,891,792		\$ 8,295,994	

Mortgage loan originations volume - Home purchases										
Mortgage loan originations volume - Refinancings	1,893,680		2,483,342		4,183,835		3,460,327		2,067,854	
Mortgage loan originations volume - Total	13,692,484		14,457,913		15,460,213		13,352,119		10,363,848	
Mortgage loan sales volume	13,735,885		14,454,260		15,155,340		13,129,069		10,164,350	
Insurance Segment: Net loss and LAE ratio	58.0	%	66.6	%	57.4	%	61.1	%	57.4	%
Expense ratio	39.0	%	39.9	%	33.5	%	33.8	%	31.9	%
Combined ratio	97.0	%	106.5	%	90.9	%	94.9	%	89.3	%
Statutory surplus (11)	\$ 96,545		\$ 116,590		\$ 161,790		\$ 152,342		\$ 141,987	
Statutory premiums to surplus ratio	138.6	%	117.5	%	92.3	%	105.4	%	115.8	%

- (1) Series B preferred stock was redeemed in April 2015.
- (2) Dividend payout ratio is defined as cash dividends declared per common share divided by basic earnings per common share.
- (3) At the close of business on September 30, 2018, the loss-share agreements with the FDIC for commercial assets expired, except for certain obligations on the part of the Bank that survived. On October 17, 2018, the Bank and the FDIC entered into a Termination Agreement pursuant to which all rights and obligations under each of the loss-share agreements with the FDIC were resolved and terminated. As such, all loans previously identified as either “covered loans” or “non-covered loans” are now collectively referred to as “loans held for investment” for all periods presented. In addition, the allowance for loan losses on the aforementioned loans held for investment is presented as one combined line item for all periods presented.
- (4) Noted measures are typically used for measuring the performance of banking and financial institutions.
- (5) Noted measures during 2017 include estimated non-cash, non-recurring charges to Hilltop consolidated and banking segment results of \$28.4 million and \$25.7 million, respectively, primarily attributable to the revaluation of deferred tax assets as a result of the enactment of the Tax Cuts and Jobs Act of 2017 (“the Tax Legislation”). Deferred tax asset amounts recorded in December 2017 following enactment of the Tax Legislation were final as of September 30, 2018.
- (6) Net interest margin is defined as net interest income divided by average interest-earning assets.
- (7) Net interest margin (taxable equivalent), a non-GAAP measure, is defined as taxable equivalent net interest income divided by average interest-earning assets. Taxable equivalent adjustments are based on a 21% federal income tax rate for 2018 periods presented and 35% federal income tax rate for all previous periods presented. The interest income earned on certain earning assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than taxable investments. To provide more meaningful comparisons of net interest margins for all earning assets, we use net interest income on a taxable-equivalent basis in calculating net interest margin by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income earned on taxable investments. For the periods presented, the taxable equivalent adjustments to interest income for Hilltop consolidated were \$0.9 million, \$2.2 million, \$2.4 million, \$3.0 million and \$2.3 million, respectively, and for the banking segment were \$0.8 million, \$1.6 million, \$1.5 million, \$1.8 million and \$2.0 million, respectively.
- (8) Common equity Tier 1 risk-based capital ratio applicable for reporting periods beginning after January 1, 2015.
- (9)

Efficiency ratio is defined as noninterest expenses divided by the sum of total noninterest income and net interest income for the year.

- (10) Net revenue is defined as the sum of total broker-dealer net interest income plus total broker-dealer noninterest income.
- (11) Statutory surplus includes combined surplus of NLIC and ASIC.

#### GAAP Reconciliation and Management's Explanation of Non-GAAP Financial Measures

We present two measures in our selected financial data that are not measures of financial performance recognized by GAAP. "Tangible book value per common share" is defined as our total stockholders' equity, excluding preferred stock, reduced by goodwill and other intangible assets, divided by total common shares outstanding. "Tangible common equity to tangible assets" is defined as our total stockholders' equity, excluding preferred stock, reduced by goodwill and other intangible assets divided by total assets reduced by goodwill and other intangible assets. These measures are important to investors interested in changes from period to period in tangible common equity per share exclusive of changes in intangible assets. For companies such as ours that have engaged in business combinations, purchase accounting can result in the recording of significant amounts of goodwill and other intangible assets related to those transactions.

Table of Contents

You should not view this disclosure as a substitute for results determined in accordance with GAAP, and our disclosure is not necessarily comparable to that of other companies that use non-GAAP measures.

The following table reconciles these non-GAAP financial measures to the most comparable GAAP financial measures, “book value per common share” and “Hilltop stockholders’ equity to total assets” (dollars in thousands, except per share data).

	December 31, 2018	2017	2016	2015	2014
Book value per common share	\$ 20.83	\$ 19.92	\$ 18.98	\$ 17.56	\$ 14.93
Effect of goodwill and intangible assets per share	\$ (3.52)	\$ (3.00)	\$ (3.01)	\$ (3.10)	\$ (3.46)
Tangible book value per common share	\$ 17.31	\$ 16.92	\$ 15.97	\$ 14.46	\$ 11.47
Hilltop stockholders’ equity	\$ 1,949,470	\$ 1,912,081	\$ 1,870,509	\$ 1,736,954	\$ 1,460,452
Less: preferred stock	—	—	—	—	114,068
Less: goodwill and intangible assets, net	329,440	288,240	296,503	306,676	311,591
Tangible common equity	1,620,030	1,623,841	1,574,006	1,430,278	1,034,793
Total assets	13,683,572	13,365,786	12,738,062	11,867,001	9,242,416
Less: goodwill and intangible assets, net	329,440	288,240	296,503	306,676	311,591
Tangible assets	13,354,132	13,077,546	12,441,559	11,560,325	8,930,825
Equity to assets	14.25	% 14.31	% 14.68	% 14.64	% 15.80
Tangible common equity to tangible assets	12.13	% 12.42	% 12.65	% 12.37	% 11.59

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion is intended to help the reader understand our results of operations and financial condition and is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements and the accompanying notes thereto commencing on page F-1. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our results and the timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under “Item 1A. Risk Factors” and elsewhere in this Annual Report. See “Forward-Looking Statements.”

Unless the context otherwise indicates, all references in this Management’s Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, to the “Company,” “we,” “us,” “our” or “ours” or similar words are to Hilltop Holdings Inc. and its direct and indirect wholly owned subsidiaries, references to “Hilltop” refer solely to Hilltop Holdings Inc., references to “PCC” refer to PlainsCapital Corporation (a wholly owned subsidiary of Hilltop), references to “Securities Holdings” refer to Hilltop Securities Holdings LLC (a wholly owned subsidiary of Hilltop), references to “Hilltop Securities” refer to Hilltop Securities Inc. (a wholly owned subsidiary of Securities Holdings), references to “HTS Independent Network” refer to Hilltop Securities Independent Network Inc. (a wholly owned subsidiary of Securities Holdings), Hilltop Securities and HTS Independent Network are collectively referred to as the “Hilltop Broker-Dealers”, references to the “Bank” refer to PlainsCapital Bank (a wholly owned subsidiary of PCC), references to “FNB” refer to First National Bank, references to “SWS” refer to the former SWS Group, Inc., references to “First Southwest” refer to First Southwest Holdings, LLC (a wholly owned subsidiary of Securities Holdings) and its subsidiaries as a whole, references to “FSC” refer to First Southwest Company, LLC (a former wholly owned subsidiary of First Southwest), references to “PrimeLending” refer to PrimeLending, a PlainsCapital Company (a wholly owned subsidiary of the Bank) and its subsidiaries as a whole, references to “NLC” refer to National Lloyds Corporation (a wholly owned subsidiary of Hilltop) and its subsidiaries as a whole, references to “NLIC” refer to National Lloyds Insurance Company (a wholly owned subsidiary of NLC) and references to “ASIC” refer to American Summit Insurance Company (a wholly owned subsidiary of NLC).



Table of Contents

OVERVIEW

We are a financial holding company registered under the Bank Holding Company Act of 1956. Our primary line of business is to provide business and consumer banking services from offices located throughout Texas through the Bank. We also provide an array of financial products and services through our broker-dealer, mortgage origination and insurance segments. The following includes additional details regarding the financial products and services provided by each of our primary business units.

**PCC.** PCC is a financial holding company that provides, through its subsidiaries, traditional banking and wealth, investment and treasury management services primarily in Texas and residential mortgage loans throughout the United States.

**Securities Holdings.** 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.** 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.

During 2018, our net income to common stockholders was \$121.4 million, or \$1.28 per diluted share. We declared and paid total common dividends of \$0.28 per share, or \$26.7 million, during 2018, which resulted in a dividend payout ratio of 21.90%. Dividend payout ratio is defined as cash dividends declared per common share divided by basic earnings per common share. We also paid an aggregate of \$59.0 million to repurchase our common stock during 2018.

We reported \$160.8 million of consolidated income before income taxes during 2018, including the following contributions from our four reportable business segments.

- The banking segment contributed \$152.4 million of income before income taxes during 2018;
- The broker-dealer segment contributed \$32.6 million of income before income taxes during 2018;
- The mortgage origination segment contributed \$12.9 million of income before income taxes during 2018; and
- The insurance segment contributed \$5.7 million of income before income taxes during 2018.

At December 31, 2018, on a consolidated basis, we had total assets of \$13.7 billion, total deposits of \$8.5 billion, total loans, including loans held for sale, of \$8.3 billion and stockholders' equity of \$2.0 billion.

On January 24, 2019, our board of directors declared a quarterly cash dividend of \$0.08 per common share, payable on February 28, 2019 to all common stockholders of record as of the close of business on February 15, 2019.

### Factors Affecting Results of Operations

As a financial institution providing products and services through our banking, broker-dealer, mortgage origination and insurance segments, we are directly affected by general economic and market conditions, many of which are beyond our control and unpredictable. A key factor impacting our financial position includes changes in the level of interest rates in addition to twists in the shape of the yield curve with the magnitude and direction of the impact varying across the different lines of business. Other factors include, but are not limited to, fluctuations in volume and price levels of securities, inflation, political events, weather-related events, investor confidence, investor participation levels, legal and regulatory, and compliance requirements and competition. All of these factors have the potential to impact on our financial position, operating results and liquidity. In addition, the recent economic and political environment has led to legislative and regulatory initiatives, both enacted and proposed, that could substantially change the regulation of the financial services industry and may significantly impact us.

Table of Contents

Factors Affecting the Current Year

On August 1, 2018, we acquired privately-held, Houston-based The Bank of River Oaks (“BORO”) in an all-cash transaction (the “BORO Acquisition”). Pursuant to the terms of the definitive agreement, we paid cash in the aggregate amount of \$85 million to the shareholders and option holders of BORO. The fair value of the assets acquired was \$434.8 million, including \$326.6 million in loans, while the fair value of liabilities assumed was \$389.4 million, consisting primarily of \$376.4 million in deposits. The operations of BORO were included in our operating results beginning August 1, 2018. The estimated fair value of the core deposit intangible asset acquired as of August 1, 2018 was \$10.0 million and resulting goodwill was \$39.6 million. In connection with the acquisition, we merged BORO into the Bank, and all customer accounts were converted to the PlainsCapital Bank platform.

On August 3, 2018, we made a \$24.6 million investment in a new real estate development in Dallas’ University Park. This investment consisted of \$5.3 million for the building, which is currently under construction, and \$19.3 million for the land on which the building is being constructed. Joining Hilltop in the transaction is our chairman and largest shareholder, Gerald J. Ford, who will be an equal investing partner in the project. Hilltop and the Ford family each own 25% of the 119,000-square-foot commercial office building and 50% of the 1.7-acre tract on which the building will sit. Construction commenced in the fourth quarter of 2017, and total construction costs are expected to be approximately \$62 million. Hilltop and the Bank have agreed to lease approximately 68,000 square feet of corporate office space in the building as well as an approximate 4,000-square-foot PlainsCapital Bank branch for an average cost of \$3.1 million per year and \$0.3 million per year, respectively, over the initial 129-month terms. The building will be named Hilltop Plaza and is expected to serve as headquarters for both Hilltop and the Bank beginning in the fourth quarter of 2019.

On October 23, 2018, PrimeLending entered into a Settlement Agreement and an Indemnification Agreement with the DOJ and HUD, respectively. In these agreements, PrimeLending did not admit to any liability or wrongdoing, and the DOJ and HUD did not make any concessions with respect to their alleged claims. These agreements provide for payments of \$13.5 million to the DOJ and HUD in the aggregate. In exchange for these payments, each of the DOJ and HUD released any civil claims they may have related to certain loans originated by PrimeLending. The payments were made to the DOJ and HUD during the fourth quarter of 2018 and the indemnification liability related to this matter was released. Accordingly, our operating results or financial condition will not be impacted by this matter in future periods.

At the close of business on September 30, 2018, the loss-share agreement for commercial assets with the FDIC expired, except for certain obligations on the part of the Bank that survived. On October 17, 2018, the Bank and the FDIC entered into a Termination Agreement pursuant to which each of the loss-share agreements terminated in exchange for the payment by the FDIC to the Bank of \$6.26 million. These funds were received on October 19, 2018. Pursuant to the Termination Agreement, all rights and obligations of the Bank and the FDIC under the FDIC loss-share agreements, including, among others, the true-up provisions and the settlement of loss-share and expense reimbursement claims, have been resolved and terminated. In October 2018, in conjunction with the receipt of the \$6.26 million noted above, the FDIC Indemnification Asset of \$22.8 million and the FDIC true-up accrual of \$16.6 million were removed with no further impact to the Company’s consolidated statements of operations. The balance of

the FDIC Indemnification Asset at December 31, 2017 is included in other assets within the consolidated balance sheets. Additionally, loans which were previously referred to as either “covered loans” if covered by the loss-share agreements or otherwise “non-covered loans” are now collectively referred to as “loans held for investment.” In addition, the allowance for loan losses on the aforementioned loans held for investment is presented as one combined line item for all periods presented. Similarly, other real estate owned (“OREO”) which was previously referred to as “covered OREO” if covered by the loss-share agreements or otherwise “non-covered OREO” is now collectively referred to as OREO and included in other assets within the consolidated balance sheets.

#### Factors Affecting Prior Years

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (“Tax Legislation”) was enacted. The Tax Legislation significantly revised the U.S. corporate income tax by lowering corporate income tax rates. Our results during 2017 included the estimated impact of a non-recurring, non-cash charge of \$28.4 million as a result of the enactment of the Tax Legislation. The charge was primarily due to the revaluation of deferred tax assets as a result of the reduction in the corporate tax rate from 35% to 21%, and other anticipated impacts associated with the Tax Legislation. Deferred tax asset amounts recorded in December 2017 following enactment of the Tax Legislation were final as of September 30, 2018. The charge resulting from the Tax Legislation is expected to be recovered through lower projected effective tax rates due to reduction of the corporate tax rate to 21%, which we expect to be partially offset by the loss of deductions for certain

## Table of Contents

expenses. In addition, the Tax Legislation eliminates our ability to carryback any net operating losses against prior period taxable income in future years, which impacts the amount of the allowable deferred tax assets included in our common equity Tier 1 capital in our capital calculations, starting in 2018.

During August and September 2017, Hurricanes Harvey and Irma affected both the Company and its customers. The estimated pre-tax earnings impact from these hurricanes on our 2017 operating results was \$8.2 million. Specifically, within our insurance segment, the total estimated loss and loss adjustment expenses (“LAE”) incurred associated with the hurricanes was \$19.3 million at December 31, 2017. However, since the losses exceeded excess of loss retention coverage, net exposure to the insurance segment was \$4.4 million retention and \$1.4 million in reinstatement premiums. The effect on our broker-dealer segment’s operating results were limited to \$0.3 million associated with waived customer fees. While the mortgage origination and banking segments did not identify any immediate losses based on client interactions and the review of collateral domiciled in the affected areas, each recorded loss estimates within its third quarter 2017 operating results. As of December 31, 2017, the mortgage origination segment held a \$0.1 million indemnification liability reserve associated with loss exposures related to funded loans, not yet sold into the secondary markets, as well as loans upon which it owns the mortgage servicing rights. The banking segment reflected \$2.0 million associated with estimated hurricane loss exposures within the qualitative factors used to determine its allowance for loan losses during the year ended December 31, 2017.

Additionally, during 2017, our consolidated income before taxes included the recognition within corporate of a pre-tax net increase to other noninterest income of \$11.6 million related to the resolution of the appraisal proceedings from the January 1, 2015 acquisition of SWS (the “SWS Merger”) as discussed in detail in Note 18, Commitments and Contingencies.

During 2016, the Bank discovered irregularities with respect to a loan that was in default, including the genuineness of certain underlying documents that supported the loan and the operations of the borrower’s business. As a result of the payment default and other irregularities, the Bank increased its provision for loan losses and recorded a \$24.5 million charge-off during the second quarter of 2016, representing the entire outstanding principal balance of the loan. The banking segment’s financial results for 2016 reflect this charge-off. During the second quarter of 2017, the bank recorded other noninterest income of \$15.0 million from coverage provided by an insurance policy for forgery of a document delivered in connection with this loan. The Bank is actively pursuing legal remedies to recover losses arising from this isolated incident, including litigation against the borrower and guarantors. The Bank cannot currently estimate the amount of any future recoveries or additional expenses related to this charged-off loan.

## Technology Enhancements and Corporate Initiatives

In furtherance of our goal of building a premier, diversified financial services company, we regularly evaluate strategic opportunities to invest in our business and technology platforms. Such investments are intended to support long-term technological competitiveness and improved operational efficiencies throughout our organization. During 2018, we made significant investment in new technological solutions, substantial core system upgrades and other

technology enhancements, and we are working on preliminary plans for additional investments in such solutions, upgrades and enhancements. In combination with these technology enhancements, we have begun the consolidation of common back office functions. During 2018, we incurred approximately \$10 million in expenses related to core system replacements and other technology enhancements. We believe that costs incurred related to these technology investments and corporate initiatives will continue to represent an increasingly significant portion of our noninterest expenses in the near term, but we are making such investments with the expectation that they will result in cost savings over the long term.

## Company Background

In January 2007, we acquired NLC, a property and casualty insurance holding company. As a result, our subsequent primary operations through November 2012 were limited to providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the southern United States through NLC's wholly owned subsidiaries, NLIC and ASIC.

On November 30, 2012, we acquired PlainsCapital Corporation pursuant to a plan of merger whereby PlainsCapital Corporation merged with and into our wholly owned subsidiary (the "PlainsCapital Merger"), which continued as the surviving entity under the name "PlainsCapital Corporation". Concurrent with the consummation of the PlainsCapital Merger, Hilltop became a financial holding company registered under the Bank Holding Company Act of 1956.

## Table of Contents

On September 13, 2013 (the “Bank Closing Date”), the Bank assumed substantially all of the liabilities, including all of the deposits, and acquired substantially all of the assets of Edinburg, Texas-based FNB from the Federal Deposit Insurance Corporation (the “FDIC”), as receiver, and reopened former branches of FNB acquired from the FDIC under the “PlainsCapital Bank” name (the “FNB Transaction”). Pursuant to the Purchase and Assumption Agreement by and among the FDIC as receiver for FNB, the FDIC and the Bank (the “P&A Agreement”), the Bank and the FDIC entered into loss-share agreements whereby the FDIC agreed to share in the losses of certain loans and other real estate owned (“OREO”) that the Bank acquired in the FNB Transaction. As previously discussed, the loss-share agreements with the FDIC were terminated in the fourth quarter of 2018.

On August 1, 2018, we acquired privately-held, Houston-based The Bank of River Oaks (“BORO”) in an all-cash transaction (the “BORO Acquisition”) as discussed above. In connection with the acquisition, we merged BORO into the Bank, and all customer accounts were converted to the PlainsCapital Bank platform.

## Segment Information

We have three primary business units, PCC (banking and mortgage origination), Securities Holdings (broker-dealer) and NLC (insurance). Under accounting principles generally accepted in the United States (“GAAP”), our business units are comprised of four reportable business segments organized primarily by the core products offered to the segments’ respective customers: banking, broker-dealer, mortgage origination and insurance. Consistent with our historical segment operating results, we anticipate that future revenues will be driven primarily from the banking segment, with the remainder being generated by our broker-dealer, mortgage origination and insurance segments. Operating results for the mortgage origination segment have historically been more volatile than operating results for the banking, broker-dealer and insurance segments.

The banking segment includes the operations of the Bank, and since August 1, 2018, the operations acquired in the BORO Acquisition, which primarily provides business and consumer banking services from offices located throughout Texas and generates revenue from its portfolio of earning assets. The Bank’s results of operations are primarily dependent on net interest income, while also deriving revenue from other sources, including service charges on customer deposit accounts and trust fees.

The broker-dealer segment includes the operations of Hilltop Securities and HTS Independent Network and included the operations of FSC through January 22, 2016. The broker-dealer segment generates a majority of its revenues from fees and commissions earned from investment advisory and securities brokerage services. Hilltop Securities is a broker-dealer registered with the Securities and Exchange Commission (the “SEC”) and the 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. Hilltop Securities, HTS Independent Network and Hilltop Securities Asset Management, LLC, formerly known as First Southwest Asset Management,

LLC, a wholly-owned subsidiary of First Southwest Holdings, LLC, are registered investment advisers under the Investment Advisers Act of 1940.

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

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

Corporate includes certain activities not allocated to specific business segments. These activities include holding company financing and investing activities, merchant banking investment opportunities, and management and administrative services to support the overall operations of the Company.



Table of Contents

The elimination of intercompany transactions are included in “All Other and Eliminations.” Additional information concerning our reportable segments is presented in Note 30, Segment and Related Information, in the notes to our consolidated financial statements. The following tables present certain information about the operating results of our reportable segments (in thousands).

Year Ended December 31, 2018	Banking	Broker-Dealer	Mortgage Origination	Insurance	Corporate	All Other and Eliminations
Net interest income (expense)	\$ 370,732	\$ 50,878	\$ 1,485	\$ 3,025	\$ (9,176)	\$ 19,380
Provision (recovery) for loan losses	5,319	(231)	—	—	—	—
Noninterest income	43,588	301,714	551,860	142,565	4,893	(21,830)
Noninterest expense	256,577	320,241	540,474	139,921	36,628	(592)
Income (loss) before income taxes	\$ 152,424	\$ 32,582	\$ 12,871	\$ 5,669	\$ (40,911)	\$ (1,858)

Year Ended December 31, 2017	Banking	Broker-Dealer	Mortgage Origination	Insurance	Corporate	All Other and Eliminations
Net interest income (expense)	\$ 366,581	\$ 43,735	\$ (915)	\$ 2,861	\$ (10,069)	\$ 19,555
Provision (recovery) for loan losses	14,073	198	—	—	—	—
Noninterest income	59,904	368,421	632,388	151,382	12,798	(19,829)
Noninterest expense	248,404	347,314	581,899	158,354	33,983	(699)
Income (loss) before income taxes	\$ 164,008	\$ 64,644	\$ 49,574	\$ (4,111)	\$ (31,254)	\$ 425

Year Ended December 31, 2016	Banking	Broker-Dealer	Mortgage Origination	Insurance	Corporate	All Other and Eliminations
Net interest income (expense)	\$ 363,083	\$ 31,172	\$ (11,589)	\$ 3,164	\$ (7,257)	\$ 18,958
Provision (recovery) for loan losses	40,673	(53)	—	—	—	—
Noninterest income	52,579	385,766	704,126	164,841	2	(20,349)
Noninterest expense	244,715	377,524	614,741	146,601	29,938	(1,048)
Income (loss) before income taxes	\$ 130,274	\$ 39,467	\$ 77,796	\$ 21,404	\$ (37,193)	\$ (343)

## How We Generate Revenue

We generate revenue from net interest income and from noninterest income. Net interest income represents the difference between the income earned on our assets, including our loans and investment securities, and our cost of

funds, including the interest paid on the deposits and borrowings that are used to support our assets. Net interest income is a significant contributor to our operating results. Fluctuations in interest rates, as well as the amounts and types of interest-earning assets and interest-bearing liabilities we hold, affect net interest income. We generated \$436.3 million in net interest income during 2018, compared with net interest income of \$421.7 million and \$397.5 million during 2017 and 2016, respectively. Changes in net interest income during 2018, compared with 2017, and during 2017, compared with 2016, primarily included increases within our banking, broker-dealer and mortgage origination segments.

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

- (i) Income from broker-dealer operations. Through Securities Holdings, we provide investment banking and other related financial services that generated \$241.0 million, \$266.3 million and \$273.9 million in securities brokerage commissions and fees and investment advisory fees and commissions, and \$47.8 million, \$91.1 million and \$102.2 million in gains on derivative and trading portfolio activities (included within other noninterest income) during 2018, 2017 and 2016, respectively.
- (ii) Income from mortgage operations. Through PrimeLending, we generate noninterest income by originating and selling mortgage loans. During 2018, 2017 and 2016, we generated \$548.7 million, \$632.4 million and \$703.3 million, respectively, in net gains from sale of loans, other mortgage production income (including income associated with retained mortgage servicing rights), and mortgage loan origination fees.
- (iii) Income from insurance operations. Through NLC, we provide fire and homeowners insurance for low value dwellings and manufactured homes. The insurance segment generated \$136.8 million, \$142.3 million and \$155.5 million in net insurance premiums earned during 2018, 2017 and 2016, respectively.

In the aggregate, we generated \$1.0 billion, \$1.2 billion and \$1.3 billion in noninterest income during 2018, 2017 and 2016, respectively. The decrease in noninterest income during 2018, compared with 2017, was predominantly attributable to decreases of \$93.4 million in net gains from sale of loans and other mortgage production income, \$43.3 million in gains from derivative and trading portfolio activities and \$19.9 million in investment and securities advisory fees and commissions. Additionally, our results for 2017 reflect \$15.0 million of other noninterest income within the banking segment related to coverage provided by an insurance policy for forgery, and \$11.6 million within corporate related to the resolution of the appraisal proceedings from the SWS Merger, both of which were nonrecurring. The decrease in

Table of Contents

noninterest income during 2017, compared with 2016, was primarily due to decreases in noninterest income in our mortgage origination, broker-dealer and insurance segments, partially offset by increases in noninterest income due to the previously mentioned increase in other noninterest income of \$15.0 million within the banking segment and the \$11.6 million increase within corporate related to the resolution of the appraisal proceedings from the SWS Merger.

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

## Consolidated Operating Results

Net income applicable to common stockholders during 2018 was \$121.4 million, or \$1.28 per diluted share, compared with net income applicable to common stockholders of \$132.5 million, or \$1.36 per diluted share, during 2017, and net income applicable to common stockholders of \$145.9 million, or \$1.48 per diluted share, during 2016. See "Factors Affecting Results of Operations" above for details regarding significant items that affected our operating results in 2018 and 2017. The consolidated operating results during 2016 included the previously mentioned \$24.5 million charge-off of a single large loan by the Bank and a specific legal reserve of \$16.0 million related to one matter involving Hilltop Securities that was settled in the first quarter of 2017.

Our consolidated operating results during 2018 also included \$8.2 million of pre-tax transaction costs related to the BORO Acquisition. Our consolidated operating results during 2017 included \$2.1 million of pre-tax transaction costs related to the SWS Merger, while our consolidated operating results during 2016 included \$7.4 million of pre-tax transaction costs and \$5.9 million of integration-related costs associated with employee expenses (such as severance and retention), professional fees (such as consulting and legal) and contractual costs (such as vendor contract termination and lease), as a result of the integration of the operations and systems acquired in the SWS Merger.

Certain items included in net income for 2018, 2017 and 2016 resulted from purchase accounting associated with the PlainsCapital Merger, the FNB Transaction, the SWS Merger and the BORO Acquisition (collectively, the "Bank Transactions"). Income before income taxes during 2018, 2017 and 2016 included the following purchase accounting items related to the Bank Transactions (in thousands).

Year Ended December 31, 2018	PlainsCapital Merger	FNB Transaction	SWS Merger	BORO Acquisition	Total
Net accretion on earning assets and liabilities	\$ 2,426	\$ 28,373	\$ 1,922	\$ 4,909	\$ 37,630
Amortization of identifiable intangibles	(5,643)	(412)	(781)	(1,190)	(8,026)

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Year Ended December 31, 2017	PlainsCapital Merger	FNB Transaction	SWS Merger	BORO Acquisition	Total
Net accretion on earning assets and liabilities	\$ 5,333	\$ 47,677	\$ 3,080	\$ -	\$ 56,090
Amortization of identifiable intangibles	(6,322)	(565)	(866)	-	(7,753)
Year Ended December 31, 2016	PlainsCapital Merger	FNB Transaction	SWS Merger	BORO Acquisition	Total
Net accretion on earning assets and liabilities	\$ 9,662	\$ 50,697	\$ 4,556	\$ -	\$ 64,915
Amortization of identifiable intangibles	(7,869)	(719)	(952)	-	(9,540)

As mentioned in the “Factors Affecting Results of Operations” section above, the Bank terminated its loss-share agreements with the FDIC in the fourth quarter of 2018, resulting in a \$6.26 million payment from the FDIC to the Bank. Prior to the termination, the Bank recorded “true-up” accruals with respect to the FNB Transaction loss-share agreements with the FDIC of \$2.1 million in 2017 and \$8.7 million in 2016. The true-up accrual was based on a formula within the loss-share agreements, pursuant to which we agreed to reimburse the FDIC if actual losses incurred and billed to the FDIC through loss sharing were below a stated threshold. In 2018, the Bank also recorded \$6.5 million of amortization of excess book value of its receivables under the loss-share agreements (the “FDIC Indemnification Asset”) due to lower projected collections from the FDIC than were initially estimated at the acquisition date.

Table of Contents

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

	Year Ended December		
	31,		
	2018	2017	2016
Return on average stockholder's equity	6.33 %	7.00 %	8.13 %
Return on average assets	0.93 %	1.03 %	1.21 %
Net interest margin (1) (2) (4) (5)	3.55 %	3.61 %	3.68 %
Net interest margin (taxable equivalent) (2) (3) (4) (5)	3.56 %	3.63 %	3.71 %

- (1) Net interest margin is defined as net interest income divided by average interest-earning assets.
- (2) Noted measures during 2017 and 2016 reflect certain asset category reclassifications within the detailed calculations to conform with the current period presentation.
- (3) Net interest margin (taxable equivalent), a non-GAAP measure, is defined as taxable equivalent net interest income divided by average interest earning assets. Taxable equivalent adjustments are based on the applicable corporate federal income tax rates of 21% for 2018 and 35% for 2017 and 2016. The interest income earned on certain earning assets is completely or partially exempt from federal income tax. See footnote 2 to the consolidated net interest income table below for the taxable equivalent adjustments to interest income.
- (4) The securities financing operations within our broker-dealer segment had the effect of lowering both net interest margin and taxable equivalent net interest margin by 42 basis points, 48 basis points and 55 basis points during 2018, 2017 and 2016, respectively.
- (5) During 2018, 2017 and 2016, purchase accounting contributed 34 basis points, 52 basis points and 66 basis points, respectively, to net interest margin and taxable equivalent net interest margin.

We present net interest margin in the previous table, and net interest margin and net interest income below, on a taxable-equivalent basis. The interest income earned on certain earning assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than taxable investments. To provide more meaningful comparisons of net interest margins for all earning assets, we use net interest income on a taxable-equivalent basis in calculating net interest margin by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income earned on taxable investments.

During 2018, 2017 and 2016, purchase accounting contributed 34, 52 and 66 basis points to our consolidated taxable equivalent net interest margin of 3.56%, 3.63% and 3.71%, respectively, and primarily related to the following purchase accounting items associated with the Bank Transactions (in thousands).

Year Ended December 31, 2018	PlainsCapital Merger	FNB Transaction	SWS Merger	BORO Acquisition	Total
Accretion of discount on loans	\$ 3,689 (1,263)	\$ 28,373 -	\$ 2,123 -	\$ 4,909 -	\$ 39,094 (1,263)

Amortization of premium on  
acquired securities

Year Ended December 31, 2017	PlainsCapital Merger	FNB Transaction	SWS Merger	BORO Acquisition	Total
Accretion of discount on loans	\$ 7,879	\$ 47,677	\$ 2,889	\$ -	\$ 58,444
Amortization of premium on acquired securities	(2,407)	-	-	-	(2,407)
Year Ended December 31, 2016	PlainsCapital Merger	FNB Transaction	SWS Merger	BORO Acquisition	Total
Accretion of discount on loans	\$ 12,938	\$ 50,697	\$ 4,235	\$ -	\$ 67,870
Amortization of premium on acquired securities	(3,083)	-	-	-	(3,083)

Table of Contents

The table below provides additional details regarding our consolidated net interest income (dollars in thousands). The 2016 detailed calculations reflect certain asset category reclassifications to conform with the current period presentation.

	Year Ended December 31, 2018				2017				2016
	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate	%	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate	%	Average Outstanding Balance
<b>Assets</b>									
<b>Interest-earning assets</b>									
Loans held for sale	\$ 1,472,772	\$ 68,536	4.65	%	\$ 1,541,000	\$ 64,344	4.18	%	\$ 1,541,000
Loans held for investment, gross (1)	6,601,453	368,189	5.58	%	6,177,933	347,644	5.63	%	5,987,933
Investment securities - taxable	1,680,976	50,860	3.03	%	1,399,379	36,378	2.60	%	1,399,379
Investment securities - non-taxable (2)	247,651	7,752	3.13	%	234,741	8,012	3.41	%	234,741
Federal funds sold and securities purchased under agreements to resell	189,183	2,831	1.50	%	140,337	923	0.66	%	140,337
Interest-bearing deposits in other financial institutions	459,628	8,683	1.89	%	572,829	6,114	1.07	%	572,829
Securities borrowed	1,542,539	66,914	4.34	%	1,518,041	41,048	2.70	%	1,518,041
Other	74,684	6,535	8.75	%	85,550	4,897	5.72	%	85,550
Interest-earning assets, gross (2)	12,268,886	580,300	4.73	%	11,669,810	509,360	4.36	%	11,669,810
Allowance for loan losses	(62,681)				(59,153)				(59,153)
Interest-earning assets, net	12,206,205				11,610,657				11,610,657
Noninterest-earning assets	1,288,718				1,345,174				1,345,174
Total assets	\$ 13,494,923				\$ 12,955,831				\$ 12,955,831
<b>Liabilities and Stockholders' Equity</b>									

Interest-bearing liabilities										
Interest-bearing deposits	\$ 5,568,473	\$ 46,002	0.83	%	\$ 5,220,359	\$ 24,695	0.47	%	\$ 4	
Securities loaned	1,395,947	56,733	4.06	%	1,378,748	32,337	2.35	%	1	
Notes payable and other borrowings	1,477,966	40,369	2.73	%	1,515,874	28,376	1.87	%	1	
Total interest-bearing liabilities	8,442,386	143,104	1.70	%	8,114,981	85,408	1.05	%	7	
Noninterest-bearing liabilities										
Noninterest-bearing deposits	2,504,599				2,309,776				2	
Other liabilities	617,227				634,630				6	
Total liabilities	11,564,212				11,059,387				1	
Stockholders' equity	1,919,940				1,894,009				1	
Noncontrolling interest	10,771				2,435				2	
Total liabilities and stockholders' equity	\$ 13,494,923				\$ 12,955,831				\$ 1	
Net interest income (2)		\$ 437,196				\$ 423,952				
Net interest spread (2)			3.03	%			3.31	%		
Net interest margin (2)			3.56	%			3.63	%		

(1) Average balance includes non-accrual loans.

(2) Presented on a taxable equivalent basis with taxable equivalent adjustments based on a 21% federal income tax rate for and a 35% federal income tax rate for 2017 and 2016. The adjustment to interest income was \$0.9 million, \$2.2 million and \$2.4 million during 2018, 2017 and 2016, respectively.

The banking segment's net interest margin exceeds our consolidated net interest margin shown above. Our consolidated net interest margin includes certain items that are not reflected in the calculation of our net interest margin within our banking segment and reduce our consolidated net interest margin, such as the borrowing costs of Hilltop and the yields and costs associated with certain items within interest-earning assets and interest-bearing liabilities in the broker-dealer segment, including items related to securities financing operations that particularly decrease net interest margin. In addition, yields and costs on certain interest-earning assets, such as warehouse lines of credit extended to subsidiaries by the banking segment, are eliminated from the consolidated financial statements.

On a consolidated basis, net interest income increased \$14.6 million during 2018, compared with 2017, and increased \$24.2 million during 2017, compared with 2016. The increase in net interest income during 2018, compared with 2017, was primarily related to improved spreads on customer balances and an increase in net interest income earned on trading securities within our broker-dealer segment, offset by a decrease in accretion of discount on loans and changes attributable to both volumes and yields within our banking segment. The increase in net interest income during 2017, compared with 2016, was primarily related to increases in the net interest earned on mortgage-backed



securities and increases in the average stock borrowing balances in our broker-dealer segment and net volume and yield changes on the loan portfolio within our banking segment as a result of the changes in year-over-year accretion of discount on loans.

Table of Contents

The provision (recovery) for loan losses is determined by management as the amount to be added to (recovered from) the allowance for loan losses after net charge-offs have been deducted to bring the allowance to a level which, in management's best estimate, is necessary to absorb probable losses within the existing loan portfolio. The consolidated provision for loan losses, substantially all of which relates to the banking segment, was \$5.1 million, \$14.3 million and \$40.6 million during 2018, 2017 and 2016, respectively. During 2018, the provision for loan losses was comprised of charges relating to newly originated loans and acquired loans without credit impairment at acquisition of \$7.0 million and recoveries on PCI loans of \$1.9 million. The provision for loan losses during 2017 was comprised of charges relating to newly originated loans and acquired loans without credit impairment at acquisition of \$12.5 million and charges on PCI loans of \$1.8 million. The provision for loan losses during 2016 was comprised of charges relating to newly originated loans and acquired loans without credit impairment of \$41.6 million, partially offset by recoveries on PCI loans of \$1.0 million. As previously mentioned, the consolidated provision for loan losses during 2016 included a \$24.5 million charge-off of a single large loan by the Bank.

Consolidated noninterest income decreased \$182.3 million during 2018, compared with 2017, and decreased \$81.9 million during 2017, compared with 2016. Consolidated noninterest income during 2017 included the previously mentioned increase to other noninterest income of \$15.0 million in our banking segment and the pre-tax net increase to other noninterest income of \$11.6 million within corporate related to the resolution of the appraisal proceedings from the SWS Merger. The year-over-year changes in noninterest income, other than the previously mentioned non-recurring items, during 2018, compared with 2017, were primarily driven by decreases in noninterest income within our mortgage origination, broker-dealer and insurance segments. The decrease in noninterest income, during 2017, compared with 2016, of \$81.9 million, other than the items discussed in the "Factors Affecting Results of Operations" section above, was primarily driven by decreases in noninterest income within our mortgage origination, broker-dealer and insurance segments.

Consolidated noninterest expense during 2018 decreased \$76.0 million, compared with 2017, and decreased \$43.2 million during 2017, compared with 2016. The decrease in noninterest expense during 2018, compared with 2017, was primarily driven by decreases in noninterest expense within our mortgage origination, broker-dealer and insurance segments, partially offset by a wire fraud loss and BORO Acquisition-related transaction expenses incurred within the banking segment during 2018, as discussed in more detail in the banking segment discussion below. The decrease in noninterest expense during 2017, compared with 2016, primarily included decreases in noninterest expense within our mortgage origination and broker-dealer segments, partially offset by an increase within our banking segment and an increase within our insurance segment due to the effects of hurricanes as well as other weather-related losses experienced during 2017. During 2017, we incurred pre-tax transaction and integration costs related to the SWS Merger of \$2.1 million, compared with \$13.3 million during 2016.

Consolidated income tax expense during 2018, 2017 and 2016 was \$35.1 million, \$110.1 million and \$83.5 million, respectively, reflecting effective rates of 21.8%, 45.3% and 36.1%, respectively. The 2018 effective tax rate approximated statutory rates and included the effect of tax planning strategies in conjunction with the enactment of the Tax Legislation, offset by non-deductible expenses. In addition, a tax benefit was recognized from the portion of the indemnification reserve that was a deductible settlement amount. The effective tax rate during 2017 was higher than the statutory rate primarily due to the revaluation of deferred tax assets as a result of the estimated effects of the Tax

Legislation discussed above, partially offset by the previously discussed non-taxable gain recorded in the resolution of the SWS appraisal proceedings as the SWS Merger was a tax-free reorganization. Our effective tax rate during 2016 was relatively consistent with the statutory rate but did include gross effects related to non-deductible transaction costs associated with the SWS Merger, offset by the reversal of a valuation allowance of \$2.2 million previously established on a deferred tax asset associated with the SWS Merger and the recognition of excess tax benefits on share-based payment awards as a result of the adoption of Accounting Standards Update (“ASU”) 2016-09 as of January 1, 2016.

Table of Contents

## Segment Results

## Banking Segment

Income before income taxes in our banking segment during 2018, 2017 and 2016 was \$152.4 million, \$164.0 million and \$130.3 million, respectively. The decrease in income before income taxes during 2018, compared with the same period in 2017, was primarily due to a decline in accretion, increases in deposit rates, the previously mentioned BORO Acquisition-related transaction expenses, a \$4.5 million loss attributable to wire fraud and related expenses and the previously mentioned \$15.0 million of other noninterest income recognized during 2017 related to an insurance policy for forgery. These factors that contributed to the decrease in income before income taxes were partially offset by an increase in interest income associated with increases in both rate and volume on the loan portfolio and a decrease in FNB-acquired asset-related expenses. The previously mentioned wire fraud loss and related expenses were comprised of the \$4.0 million wire fraud loss and approximately \$0.5 million in costs related to the incident, all of which were expensed as incurred within the banking segment. We also may incur expenses, including legal, professional services and increased insurance expenses, and claims for damages related to this incident in the future. We have not recorded an accrual for future claims as we have not concluded that such a loss is probable. We expect available insurance coverage will reduce our overall financial exposure and we continue to seek recovery of the wire fraud loss arising from this incident. We cannot currently estimate the amount of any future legal or insurance recoveries related to this loss. The increase in income before income taxes during 2017, compared with 2016, was primarily due to the inclusion of the previously mentioned increase to other noninterest income of \$15.0 million during 2017 and the \$24.5 million charge-off within the provision for loan losses during 2016. Income before income taxes also increased during 2017, compared with 2016, due to an increase in net interest income associated with net volume and yield changes. See “Factors Affecting Results of Operations” above for the effect of hurricanes on the banking segment’s operating results during 2017.

The ratios shown in the table below include certain key indicators of the performance and asset quality of our banking segment.

	Year Ended December 31,					
	2018		2017		2016	
Efficiency ratio (1)	61.93	%	58.24	%	58.87	%
Return on average assets	1.23	%	0.85	%	0.94	%
Net interest margin (2) (4)	4.23	%	4.31	%	4.65	%
Net interest margin (taxable equivalent) (3) (4)	4.24	%	4.33	%	4.68	%
Net charge-offs to average loans outstanding	0.15	%	0.09	%	0.62	%

(1) Efficiency ratio is defined as noninterest expenses divided by the sum of total noninterest income and net interest income for the period.

(2) Net interest margin is defined as net interest income divided by average interest-earning assets.

(3)

Net interest margin (taxable equivalent), a non-GAAP measure, is defined as taxable equivalent net interest income divided by average interest earning assets. Taxable equivalent adjustments are based on the applicable corporate federal income tax rates of 21% for 2018 and 35% for 2017 and 2016. The interest income earned on certain earning assets is completely or partially exempt from federal income tax. See footnote 2 to the following table for the taxable equivalent adjustments to interest income.

- (4) During 2018, 2017 and 2016, purchase accounting contributed 48 basis points, 72 basis points and 93 basis points, respectively, to net interest margin and taxable equivalent net interest margin.

The banking segment presents net interest margin in the table above, and net interest margin and net interest income in the following discussion and tables below, on a taxable equivalent basis. The interest income earned on certain earning assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than taxable investments. To provide more meaningful comparisons of net interest margins for all earning assets, we use net interest income on a taxable equivalent basis in calculating net interest margin by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income earned on taxable investments.

During 2018, 2017 and 2016, purchase accounting contributed 48, 72 and 93 basis points, respectively, to the banking segment's taxable equivalent net interest margin of 4.24%, 4.33% and 4.68%, respectively, and primarily related to the purchase accounting items associated with the Bank Transactions as detailed in the tables presented in the Consolidated Operating Results above.

Table of Contents

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

	Year Ended December 31, 2018				2017				2016
	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate		Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate		Average Outstanding Balance
<b>Assets</b>									
<b>Interest-earning assets</b>									
Loans held for investment, gross (1)	\$ 6,032,767	\$ 342,098	5.67	%	\$ 5,695,927	\$ 326,906	5.74	%	\$ 5,29
Subsidiary warehouse lines of credit	1,364,577	58,551	4.29	%	1,436,401	54,701	3.81	%	1,26
Investment securities - taxable	965,937	22,451	2.32	%	851,066	16,275	1.91	%	714
Investment securities - non-taxable (2)	110,386	3,707	3.36	%	123,969	4,747	3.83	%	136
Federal funds sold and securities purchased under agreements to resell	1,049	16	1.54	%	5,947	50	0.85	%	28,2
Interest-bearing deposits in other financial institutions	241,124	4,429	1.84	%	316,186	3,499	1.11	%	335
Other	51,906	2,282	4.40	%	70,123	2,412	3.44	%	56,8
Interest-earning assets, gross (2)	8,767,746	433,534	4.94	%	8,499,619	408,590	4.81	%	7,83
Allowance for loan losses	(62,306)				(59,007)				(51,
Interest-earning assets, net	8,705,440				8,440,612				7,77
Noninterest-earning assets	906,586				947,484				1,03
Total assets	\$ 9,612,026				\$ 9,388,096				\$ 8,81
<b>Liabilities and Stockholders' Equity</b>									
Interest-bearing liabilities	\$ 5,237,014	\$ 55,060	1.05	%	\$ 4,932,689	\$ 33,420	0.68	%	\$ 4,52

Interest-bearing deposits									
Notes payable and other borrowings	417,534	7,000	1.68	%	741,561	6,953	0.94	%	675
Total interest-bearing liabilities	5,654,548	62,060	1.10	%	5,674,250	40,373	0.71	%	5,19
Noninterest-bearing liabilities									
Noninterest-bearing deposits	2,492,728				2,297,390				2,25
Other liabilities	48,847				48,303				57,5
Total liabilities	8,196,123				8,019,943				7,51
Stockholders' equity	1,415,903				1,368,153				1,30
Total liabilities and stockholders' equity	\$ 9,612,026				\$ 9,388,096				\$ 8,81
Net interest income (2)		\$ 371,474				\$ 368,217			
Net interest spread (2)			3.85	%			4.10	%	
Net interest margin (2)			4.24	%			4.33	%	

(1) Average balance includes non-accrual loans.

(2) Presented on a taxable equivalent basis with taxable equivalent adjustments based on the applicable corporate federal income tax rates of 21% for 2018 and 35% for 2017 and 2016. The adjustment to interest income was \$0.8 million, \$1.6 million and \$1.5 million during 2018, 2017 and 2016, respectively.

The banking segment's net interest margin exceeds our consolidated net interest margin. Our consolidated net interest margin includes certain items that are not reflected in the calculation of our net interest margin within our banking segment and reduce our consolidated net interest margin, such as the borrowing costs of Hilltop and the yields and costs associated with certain items within interest-earning assets and interest-bearing liabilities in the broker-dealer segment, including items related to securities financing operations that particularly decrease net interest margin. In addition, the banking segment's interest-earning assets include warehouse lines of credit extended to other subsidiaries, which are eliminated from the consolidated financial statements.

Table of Contents

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

	Year Ended December 31, 2018 vs. 2017			2017 vs. 2016		
	Change Due To (1)			Change Due To (1)		
	Volume	Yield/Rate	Change	Volume	Yield/Rate	Change
Interest income						
Loans held for investment, gross	\$ 19,324	\$ (4,132)	\$ 15,192	\$ 23,649	\$ (14,438)	\$ 9,211
Subsidiary warehouse lines of credit	(2,735)	6,585	3,850	6,822	(1,196)	5,626
Investment securities - taxable	2,197	3,979	6,176	2,671	(307)	2,364
Investment securities - non-taxable (2)	(520)	(520)	(1,040)	(447)	196	(251)
Federal funds sold and securities purchased under agreements to resell	(42)	8	(34)	(123)	18	(105)
Interest-bearing deposits in other financial institutions	(831)	1,761	930	(102)	1,778	1,676
Other	(627)	497	(130)	484	(147)	337
Total interest income (2)	16,766	8,178	24,944	32,954	(14,096)	18,858
Interest expense						
Deposits	\$ 2,062	\$ 19,578	\$ 21,640	\$ 1,789	\$ 11,816	\$ 13,605
Notes payable and other borrowings	(3,038)	3,085	47	359	2,961	3,320
Total interest expense	(976)	22,663	21,687	2,148	14,777	16,925
Net interest income (2)	\$ 17,742	\$ (14,485)	\$ 3,257	\$ 30,806	\$ (28,873)	\$ 1,933

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

(2) Taxable equivalent.

Taxable equivalent net interest income increased \$3.3 million during 2018, compared with 2017. Changes in the yields earned on interest-earning assets increased taxable equivalent net interest income by \$8.2 million during 2018, primarily as a result of higher yields due to increased market rates, partially offset by a decrease in accretion of discount on loans of \$19.4 million. Accretion of discount on loans is expected to continue to decrease in future periods as loans acquired in the Bank Transactions are repaid, refinanced or renewed. While we are seeing an increase in loan yields as a result of the rising interest rate environment, a portion of our loan portfolio remains at applicable rate floors, thereby causing yields on our interest-earning assets to rise more slowly than increases in market interest rates, which have also increased our borrowing costs. Absent a decline in interest rates, we believe this trend will continue until contractual rate resets allow our entire loan portfolio to reprice above applicable rate floors. Changes in the



volume of interest-earning assets, primarily due to an increase in the loan portfolio, increased taxable equivalent net interest income by \$16.8 million during 2018, compared with 2017. Changes in rates paid on interest-bearing liabilities decreased taxable equivalent net interest income by \$22.7 million during 2018, compared with 2017, due to increases in market interest rates. Short-term interest rates have risen faster than medium and longer term rates, which has reduced the favorable impact of our asset-sensitive position on net interest income. Any changes in interest rates across the term structure will continue to impact net interest income and net interest margin. The impact of rate movements will change with the shape of the yield curve, including any changes in steepness or flatness and inversions at any points on the yield curve.

Taxable equivalent net interest income increased \$1.9 million during 2017, compared with 2016. Changes in the yields earned on interest-earning assets decreased taxable equivalent net interest income by \$14.1 million during 2017, compared with 2016, primarily due to a decrease in accretion of discount on loans of \$9.4 million. Increases in the volume of interest-earning assets, primarily on the loan portfolio and additional amounts drawn on the subsidiary warehouse lines of credit, increased taxable equivalent net interest income by \$33.0 million during 2017, compared with 2016. Changes in rates paid on interest-bearing liabilities decreased taxable equivalent net interest income by \$14.8 million during 2017, compared with 2016, due to increases in market interest rates.

The banking segment's noninterest income was \$43.6 million, \$59.9 million and \$52.6 million during 2018, 2017 and 2016, respectively. The decrease during 2018, compared to 2017, was primarily due to the previously mentioned insurance receivable and related increase in other noninterest income of \$15.0 million recorded during 2017 from

Table of Contents

coverage provided by an insurance policy for forgery related to a single, large loan previously charged off by the Bank. Other than the previously mentioned increase to other noninterest income of \$15.0 million, the changes in noninterest income during 2017, compared to 2016, were primarily driven by year-over-year decreases in exchange fee income due to the impact of the Durbin amendment, which became applicable to the Bank on July 1, 2016, and intercompany financing charges.

The banking segment's noninterest expenses were \$256.6 million, \$248.4 million and \$244.7 million during 2018, 2017 and 2016, respectively. The increase during 2018, compared to 2017, was primarily due to the previously mentioned BORO acquisition-related transaction expenses and the wire fraud loss and related expenses of \$4.5 million previously discussed, partially offset by net decreases in expenses related to previously-covered assets, other real estate owned ("OREO") and other operating expenses. The change in noninterest expenses during 2017, compared with 2016, included increases in employees' compensation and benefits of \$1.8 million primarily due to increased benefit costs, net expenses associated with previously-covered assets of \$10.4 million, repossession and foreclosure expenses of \$3.2 million, as well as legal expenses associated with the Bank's previously mentioned efforts to recover losses associated with a charged-off loan. This activity was partially offset by a year-over-year decrease of \$12.5 million associated with downward valuation adjustments on a significant previously-covered OREO property recorded during 2016, as well as decreases in occupancy expenses associated with closed branches and expenses associated with organizational changes.

#### Broker-Dealer Segment

Income before income taxes in our broker-dealer segment was \$32.6 million, \$64.6 million and \$39.5 million during 2018, 2017, and 2016, respectively. The decrease in income before income taxes during 2018, compared with 2017, was primarily the result of a decrease of \$43.4 million in trading gains earned from our derivative and trading portfolio activities, most notably in our structured finance business. This decrease in trading gains was primarily due to market volatility, competitive pricing pressures, and a decrease of 19% in the structured finance business line's to-be-announced ("TBA") mortgage-backed securities volume. In addition, during 2018, our broker-dealer segment experienced a decrease of \$19.9 million in investment and securities advisory fees and commissions primarily earned on the underwriting of municipal bond transactions within our public banking business line and an increase of \$5.1 million in other noninterest expense primarily related to the purchase and development of new software solutions. These changes were partially offset by a 107-basis point increase in the federal funds rate during 2018, which led to an increase of \$3.7 million in fees earned on money market and FDIC insured bank deposits, an increase in the net interest income earned from stock lending and margin lending and a decrease in variable compensation of \$27.7 million based on less robust financial results.

The change in income before income taxes during 2017, compared with 2016, was primarily the result of a specific legal reserve of \$16.0 million during the fourth quarter of 2016 related to one matter that was settled in the first quarter of 2017, a decrease in pre-tax integration-related costs of \$5.9 million, an increase in the federal funds rate during 2017, which led to an increase of \$12.3 million in fees earned on money market and FDIC insured bank deposits, and an increase in the interest earned on mortgage-backed securities, offset by a decrease of \$8.7 million in investment banking and advisory fees primarily earned on the underwriting of municipal bond transactions and the

secondary trading of these and other municipal securities within our public banking and capital markets business lines.

The broker-dealer segment is subject to interest rate risk as a consequence of maintaining inventory positions, trading in interest rate sensitive financial instruments and maintaining a matched stock loan book. Changes in interest rates are likely to have a meaningful impact on our overall financial performance. Our broker-dealer segment has historically earned a significant portion of its revenues from advisory fees upon the successful completion of the client's transaction. Rapid or significant changes in interest rates could adversely affect the broker-dealer segment's bond trading, sales, underwriting activities and other interest spread-sensitive activities described below. The broker-dealer segment also receives administrative fees for providing money market and FDIC investment alternatives to clients, which tend to be sensitive to short term interest rates. In addition, the profitability of the broker-dealer segment depends, to an extent, on the spread between revenues earned on customer loans and excess customer cash balances, and the interest expense paid on customer cash balances, as well as the interest revenue earned on trading securities, net of financing costs.

Table of Contents

The following table provides additional details regarding our broker-dealer operating results (in thousands).

	Year Ended December 31,			Variance	
	2018	2017	2016	2018 vs 2017	2017 vs 2016
Net interest income:					
Securities lending	\$ 10,181	\$ 8,711	\$ 7,008	\$ 1,470	\$ 1,703
Structured finance	10,304	9,600	3,261	704	6,339
Clearing (1)	13,038	10,728	12,290	2,310	(1,562)
Other (1)	17,355	14,696	8,613	2,659	6,083
Total net interest income	50,878	43,735	31,172	7,143	12,563
Noninterest income:					
Securities commissions and fees by business line (2):					
Capital markets	41,146	45,915	54,992	(4,769)	(9,077)
Retail	80,625	81,075	75,271	(450)	5,804
Clearing	35,605	34,008	27,850	1,597	6,158
Other	4,847	4,475	3,698	372	777
	162,223	165,473	161,811	(3,250)	3,662
Investment and securities advisory fees and commissions by business line:					
Public banking	59,817	86,075	90,851	(26,258)	(4,776)
Capital markets	5,533	707	4,621	4,826	(3,914)
Retail	19,037	16,306	14,635	2,731	1,671
Structured finance	4,354	5,675	5,369	(1,321)	306
Clearing	1,190	1,152	515	38	637
Other	135	5	1	130	4
	90,066	109,920	115,992	(19,854)	(6,072)
Other:					
Structured finance	34,957	66,233	81,352	(31,276)	(15,119)
Capital markets	12,865	24,878	20,813	(12,013)	4,065
Other	1,603	1,917	5,798	(314)	(3,881)
	49,425	93,028	107,963	(43,603)	(14,935)
Total noninterest income	301,714	368,421	385,766	(66,707)	(17,345)
Net revenue (3)	352,592	412,156	416,938	(59,564)	(4,782)
Noninterest expense (4):					
Employees' compensation and benefits	218,467	250,614			