

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2021

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

Commission File Number: 1-31987

Hilltop Holdings Inc.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of incorporation or organization)

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

6565 Hillcrest Avenue
Dallas, TX
(Address of principal executive offices)

75205
(Zip Code)

(214) 855-2177
(Registrant's telephone number, including area code)

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

<u>Title of each class</u>	<u>Trading symbol</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$0.01 per share	HTH	New York Stock Exchange

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

The number of shares of the registrant's common stock outstanding at October 28, 2021 was 78,960,605.

HILLTOP HOLDINGS INC.
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2021

TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION

Item 1.	Financial Statements	
	Consolidated Balance Sheets	3
	Consolidated Statements of Operations	4
	Consolidated Statements of Comprehensive Income	5
	Consolidated Statements of Stockholders' Equity	6
	Consolidated Statements of Cash Flows	8
	Notes to Consolidated Financial Statements	9
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	44
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	89
Item 4.	Controls and Procedures	93

PART II — OTHER INFORMATION

Item 1.	Legal Proceedings	94
Item 1A.	Risk Factors	94
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	94
Item 6.	Exhibits	95

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)
(Unaudited)

	<u>September 30,</u> <u>2021</u>	<u>December 31,</u> <u>2020</u>
Assets		
Cash and due from banks	\$ 2,463,111	\$ 1,062,560
Federal funds sold	406	386
Assets segregated for regulatory purposes	269,506	290,357
Securities purchased under agreements to resell	155,908	80,319
Securities:		
Trading, at fair value	609,813	694,255
Available for sale, at fair value, net (amortized cost of \$1,996,995 and \$1,435,919, respectively)	1,994,183	1,462,205
Held to maturity, at amortized cost, net (fair value of \$288,112 and \$326,671, respectively)	277,419	311,944
Equity, at fair value	221	140
	2,881,636	2,468,544
Loans held for sale	2,108,878	2,788,386
Loans held for investment, net of unearned income	7,552,926	7,693,141
Allowance for credit losses	(109,512)	(149,044)
Loans held for investment, net	7,443,414	7,544,097
Broker-dealer and clearing organization receivables	1,419,652	1,404,727
Premises and equipment, net	210,026	211,595
Operating lease right-of-use assets	115,942	105,757
Mortgage servicing rights	110,931	143,742
Other assets	526,339	555,983
Goodwill	267,447	267,447
Other intangible assets, net	16,455	20,364
Total assets	\$ 17,989,651	\$ 16,944,264
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing	\$ 4,433,148	\$ 3,612,384
Interest-bearing	7,699,014	7,629,935
Total deposits	12,132,162	11,242,319
Broker-dealer and clearing organization payables	1,496,923	1,368,373
Short-term borrowings	747,040	695,798
Securities sold, not yet purchased, at fair value	113,064	79,789
Notes payable	395,804	381,987
Operating lease liabilities	134,296	125,450
Junior subordinated debentures	—	67,012
Other liabilities	468,020	632,889
Total liabilities	15,487,309	14,593,617
Commitments and contingencies (see Notes 14 and 15)		
Stockholders' equity:		
Hilltop stockholders' equity:		
Common stock, \$0.01 par value, 125,000,000 shares authorized; 78,959,055 and 82,184,893 shares issued and outstanding at September 30, 2021 and December 31, 2020, respectively	790	822
Additional paid-in capital	1,270,272	1,317,929
Accumulated other comprehensive income	367	17,763
Retained earnings	1,204,307	986,792
Deferred compensation employee stock trust, net	751	771
Employee stock trust (5,806 and 6,930 shares, at cost, at September 30, 2021 and December 31, 2020, respectively)	(116)	(138)
Total Hilltop stockholders' equity	2,476,371	2,323,939
Noncontrolling interests	25,971	26,708
Total stockholders' equity	2,502,342	2,350,647
Total liabilities and stockholders' equity	\$ 17,989,651	\$ 16,944,264

See accompanying notes.

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Interest income:				
Loans, including fees	\$ 99,769	\$ 104,955	\$ 308,208	\$ 323,983
Securities borrowed	8,585	10,705	53,143	36,915
Securities:				
Taxable	12,341	11,035	33,717	38,428
Tax-exempt	2,687	1,687	7,127	4,836
Other	1,796	1,446	4,723	5,472
Total interest income	125,178	129,828	406,918	409,634
Interest expense:				
Deposits	5,303	10,700	19,220	37,771
Securities loaned	6,519	8,729	44,350	30,802
Short-term borrowings	2,400	2,346	6,786	9,457
Notes payable	5,465	4,904	15,515	11,090
Junior subordinated debentures	419	608	1,558	2,163
Other	(18)	641	801	1,557
Total interest expense	20,088	27,928	88,230	92,840
Net interest income	105,090	101,900	318,688	316,794
Provision for (reversal of) credit losses	(5,819)	(602)	(39,648)	99,973
Net interest income after provision for (reversal of) credit losses	110,909	102,502	358,336	216,821
Noninterest income:				
Net gains from sale of loans and other mortgage production income	203,152	307,896	669,857	753,699
Mortgage loan origination fees	38,780	47,681	124,081	121,576
Securities commissions and fees	34,412	32,496	111,026	106,799
Investment and securities advisory fees and commissions	49,646	36,866	109,609	89,166
Other	41,955	77,772	110,856	171,309
Total noninterest income	367,945	502,711	1,125,429	1,242,549
Noninterest expense:				
Employees' compensation and benefits	258,679	294,907	777,518	768,156
Occupancy and equipment, net	25,428	26,124	74,861	71,820
Professional services	14,542	17,522	44,366	48,057
Other	56,525	60,792	168,459	163,422
Total noninterest expense	355,174	399,345	1,065,204	1,051,455
Income from continuing operations before income taxes	123,680	205,868	418,561	407,915
Income tax expense	28,257	46,820	97,261	93,776
Income from continuing operations	95,423	159,048	321,300	314,139
Income from discontinued operations, net of income taxes	—	736	—	34,662
Net income	95,423	159,784	321,300	348,801
Less: Net income attributable to noncontrolling interest	2,517	6,505	8,990	17,410
Income attributable to Hilltop	\$ 92,906	\$ 153,279	\$ 312,310	\$ 331,391
Earnings per common share:				
Basic:				
Earnings from continuing operations	\$ 1.16	\$ 1.69	\$ 3.84	\$ 3.29
Earnings from discontinued operations	—	0.01	—	0.38
	<u>\$ 1.16</u>	<u>\$ 1.70</u>	<u>\$ 3.84</u>	<u>\$ 3.67</u>
Diluted:				
Earnings from continuing operations	\$ 1.15	\$ 1.69	\$ 3.82	\$ 3.29
Earnings from discontinued operations	—	0.01	—	0.38
	<u>\$ 1.15</u>	<u>\$ 1.70</u>	<u>\$ 3.82</u>	<u>\$ 3.67</u>
Weighted average share information:				
Basic	80,109	90,200	81,306	90,291
Diluted	80,542	90,200	81,763	90,291

See accompanying notes.

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(Unaudited)

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Net income	\$ 95,423	\$ 159,784	\$ 321,300	\$ 348,801
Other comprehensive income:				
Change in fair value of cash flow and fair value hedges, net of tax of \$88, \$92, \$522 and \$(951), respectively	1,417	311	5,061	(3,266)
Net unrealized gains (losses) on securities available for sale, net of tax of \$(2,444), \$(99), \$(6,619) and \$4,554, respectively	(8,143)	(338)	(22,385)	15,512
Reclassification adjustment for gains (losses) included in net income, net of tax of \$0, \$1, \$(21) and \$37, respectively	<u>—</u>	<u>4</u>	<u>(72)</u>	<u>125</u>
Comprehensive income	<u>88,697</u>	<u>159,761</u>	<u>303,904</u>	<u>361,172</u>
Less: comprehensive income attributable to noncontrolling interest	<u>2,517</u>	<u>6,505</u>	<u>8,990</u>	<u>17,410</u>
Comprehensive income applicable to Hilltop	<u>\$ 86,180</u>	<u>\$ 153,256</u>	<u>\$ 294,914</u>	<u>\$ 343,762</u>

See accompanying notes.

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)
(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Deferred Compensation Employee Stock Trust, Net	Employee Stock Trust Shares	Employee Stock Trust Amount	Total Hilltop Stockholders' Equity	Noncontrolling Interest	Total Stockholders' Equity
Balance, June 30, 2020	90,222	\$ 902	\$ 1,439,686	\$ 23,813	\$ 797,331	\$ 778	8	\$ (150)	\$ 2,262,360	\$ 29,773	\$ 2,292,133
Net income	—	—	—	—	153,279	—	—	—	153,279	6,505	159,784
Other comprehensive loss	—	—	—	(23)	—	—	—	—	(23)	—	(23)
Stock-based compensation expense	—	—	3,790	—	—	—	—	—	3,790	—	3,790
Common stock issued to board members	7	—	147	—	—	—	—	—	147	—	147
Issuance of common stock related to share-based awards, net	9	—	(64)	—	—	—	—	—	(64)	—	(64)
Repurchases of common stock	—	—	29	—	(30)	—	—	—	(1)	—	(1)
Dividends on common stock (\$0.09 per share)	—	—	—	—	(8,119)	—	—	—	(8,119)	—	(8,119)
Deferred compensation plan	—	—	—	—	—	(4)	(1)	7	3	—	3
Net cash distributed to noncontrolling interest	—	—	—	—	—	—	—	—	—	(8,917)	(8,917)
Balance, September 30, 2020	90,238	\$ 902	\$ 1,443,588	\$ 23,790	\$ 942,461	\$ 774	7	\$ (143)	\$ 2,411,372	\$ 27,361	\$ 2,438,733
Balance, June 30, 2021	81,153	\$ 812	\$ 1,302,439	\$ 7,093	\$ 1,159,304	\$ 754	6	\$ (121)	\$ 2,470,281	\$ 26,095	\$ 2,496,376
Net income	—	—	—	—	92,906	—	—	—	92,906	2,517	95,423
Other comprehensive loss	—	—	—	(6,726)	—	—	—	—	(6,726)	—	(6,726)
Stock-based compensation expense	—	—	4,103	—	—	—	—	—	4,103	—	4,103
Common stock issued to board members	5	—	152	—	—	—	—	—	152	—	152
Issuance of common stock related to share-based awards, net	43	—	(441)	—	—	—	—	—	(441)	—	(441)
Repurchases of common stock	(2,242)	—	(35,981)	—	(38,157)	—	—	—	(74,160)	—	(74,160)
Dividends on common stock (\$0.12 per share)	—	—	—	—	(9,746)	—	—	—	(9,746)	—	(9,746)
Deferred compensation plan	—	—	—	—	—	(3)	—	5	2	—	2
Net cash distributed to noncontrolling interest	—	—	—	—	—	—	—	—	—	(2,641)	(2,641)
Balance, September 30, 2021	78,959	\$ 790	\$ 1,270,272	\$ 367	\$ 1,204,307	\$ 751	6	\$ (116)	\$ 2,476,371	\$ 25,971	\$ 2,502,342

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (continued)
(in thousands)
(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Deferred Compensation Employee Stock Trust, Net	Employee Stock Trust Shares	Employee Stock Trust Amount	Total Hilltop Stockholders' Equity	Noncontrolling Interest	Total Stockholders' Equity
Balance, December 31, 2019	90,641	\$ 906	\$ 1,445,233	\$ 11,419	\$ 644,860	\$ 776	8	\$ (155)	\$ 2,103,039	\$ 25,757	\$ 2,128,796
Net income	—	—	—	—	331,391	—	—	—	331,391	17,410	348,801
Other comprehensive income	—	—	—	12,371	—	—	—	—	12,371	—	12,371
Stock-based compensation expense	—	—	10,549	—	—	—	—	—	10,549	—	10,549
Common stock issued to board members	25	—	439	—	—	—	—	—	439	—	439
Issuance of common stock related to share-based awards, net	293	3	(1,091)	—	—	—	—	—	(1,088)	—	(1,088)
Repurchases of common stock	(721)	(7)	(11,542)	—	(3,701)	—	—	—	(15,250)	—	(15,250)
Dividends on common stock (\$0.27 per share)	—	—	—	—	(24,398)	—	—	—	(24,398)	—	(24,398)
Deferred compensation plan	—	—	—	—	—	(2)	(1)	12	10	—	10
Adoption of accounting standards	—	—	—	—	(5,691)	—	—	—	(5,691)	—	(5,691)
Net cash distributed to noncontrolling interest	—	—	—	—	—	—	—	—	—	(15,806)	(15,806)
Balance, September 30, 2020	90,238	\$ 902	\$ 1,443,588	\$ 23,790	\$ 942,461	\$ 774	7	\$ (143)	\$ 2,411,372	\$ 27,361	\$ 2,438,733
Balance, December 31, 2020	82,185	\$ 822	\$ 1,317,929	\$ 17,763	\$ 986,792	\$ 771	7	\$ (138)	\$ 2,323,939	\$ 26,708	\$ 2,350,647
Net income	—	—	—	—	312,310	—	—	—	312,310	8,990	321,300
Other comprehensive loss	—	—	—	(17,396)	—	—	—	—	(17,396)	—	(17,396)
Stock-based compensation expense	—	—	12,889	—	—	—	—	—	12,889	—	12,889
Common stock issued to board members	13	—	449	—	—	—	—	—	449	—	449
Issuance of common stock related to share-based awards, net	394	3	(2,694)	—	—	—	—	—	(2,691)	—	(2,691)
Repurchases of common stock	(3,633)	(35)	(58,301)	—	(65,295)	—	—	—	(123,631)	—	(123,631)
Dividends on common stock (\$0.36 per share)	—	—	—	—	(29,500)	—	—	—	(29,500)	—	(29,500)
Deferred compensation plan	—	—	—	—	—	(20)	(1)	22	2	—	2
Net cash distributed to noncontrolling interest	—	—	—	—	—	—	—	—	—	(9,727)	(9,727)
Balance, September 30, 2021	78,959	\$ 790	\$ 1,270,272	\$ 367	\$ 1,204,307	\$ 751	6	\$ (116)	\$ 2,476,371	\$ 25,971	\$ 2,502,342

See accompanying notes.

HILLTOP HOLDINGS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2021	2020
Operating Activities		
Net income	\$ 321,300	\$ 348,801
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for (reversal of) credit losses	(39,648)	99,973
Depreciation, amortization and accretion, net	18,393	15,093
Deferred income taxes	(382)	(73)
Other, net	14,049	4,145
Net change in securities purchased under agreements to resell	(75,589)	(31,072)
Net change in trading securities	84,442	21,825
Net change in broker-dealer and clearing organization receivables	(223,819)	491,035
Net change in other assets	(50,625)	(94,997)
Net change in broker-dealer and clearing organization payables	152,755	(273,013)
Net change in other liabilities	(105,402)	147,058
Net change in securities sold, not yet purchased	33,275	12,206
Proceeds from sale of mortgage servicing rights asset	116,000	18,650
Change in valuation of mortgage servicing rights asset	(12,821)	32,408
Net gains from sales of loans	(669,857)	(753,699)
Loans originated for sale	(21,563,008)	(19,351,752)
Proceeds from loans sold	22,874,493	19,417,331
Net cash provided by operating activities for continuing operations	873,556	103,919
Net cash used in operating activities for discontinued operations	—	(29,269)
Net cash provided by operating activities	873,556	74,650
Investing Activities		
Proceeds from maturities and principal reductions of securities held to maturity	34,082	69,937
Proceeds from sales, maturities and principal reductions of securities available for sale	507,365	321,049
Purchases of securities held to maturity	—	(7,553)
Purchases of securities available for sale	(1,075,154)	(704,933)
Net change in loans held for investment	360,518	(647,420)
Purchases of premises and equipment and other assets	(22,079)	(25,331)
Proceeds from sales of premises and equipment and other real estate owned	4,252	20,912
Net cash received from (paid to) Federal Home Loan Bank and Federal Reserve Bank stock	(82)	22,847
Net cash used in investing activities for continuing operations	(191,098)	(950,492)
Net cash provided by investing activities for discontinued operations	—	1,941
Net cash received from disposal of discontinued operations	—	85,499
Net cash used in investing activities	(191,098)	(863,052)
Financing Activities		
Net change in deposits	865,638	2,208,031
Net change in short-term borrowings	51,203	(645,160)
Proceeds from notes payable	739,372	1,200,343
Payments on notes payable	(792,893)	(1,060,681)
Payments to repurchase common stock	(123,631)	(15,250)
Dividends paid on common stock	(29,500)	(24,398)
Net cash distributed to noncontrolling interest	(9,727)	(15,806)
Other, net	(3,200)	(1,560)
Net cash provided by financing activities	697,262	1,645,519
Net change in cash, cash equivalents and restricted cash	1,379,720	857,117
Cash, cash equivalents and restricted cash, beginning of period	1,353,303	642,789
Cash, cash equivalents and restricted cash, end of period	\$ 2,733,023	\$ 1,499,906
Reconciliation of Cash, Cash Equivalents and Restricted Cash to Consolidated Balance Sheets		
Cash and due from banks	\$ 2,463,111	\$ 1,277,865
Federal funds sold	406	420
Assets segregated for regulatory purposes	269,506	221,621
Total cash, cash equivalents and restricted cash	\$ 2,733,023	\$ 1,499,906
Supplemental Disclosures of Cash Flow Information		
Cash paid for interest	\$ 85,069	\$ 87,798
Cash paid for income taxes, net of refunds	\$ 83,129	\$ 87,581
Supplemental Schedule of Non-Cash Activities		
Conversion of loans to other real estate owned	\$ 2,924	\$ 13,669
Additions to mortgage services rights	\$ 70,368	\$ 123,266

See accompanying notes.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

1. Summary of Significant Accounting and Reporting Policies

Nature of Operations

Hilltop Holdings Inc. (“Hilltop” and, collectively with its subsidiaries, the “Company”) is a financial holding company registered under the Bank Holding Company Act of 1956. The Company’s primary line of business is to provide business and consumer banking services from offices located throughout Texas through PlainsCapital Bank (the “Bank”). In addition, the Company provides an array of financial products and services through its broker-dealer and mortgage origination subsidiaries.

On June 30, 2020, Hilltop completed the sale of all of the outstanding capital stock of National Lloyds Corporation (“NLC”), which comprised the operations of the former insurance segment, for cash proceeds of \$154.1 million, and was subject to post-closing adjustments. Accordingly, NLC’s results for the three and nine months ended September 30, 2020 have been presented as discontinued operations in the consolidated financial statements. For further details, see Note 3 to the consolidated financial statements.

The Company, headquartered in Dallas, Texas, provides its products and services through two primary business units within continuing operations, PlainsCapital Corporation (“PCC”) and Hilltop Securities Holdings LLC (“Securities Holdings”). PCC is a financial holding company that provides, through its subsidiaries, traditional banking, wealth and investment management and treasury management services primarily in Texas and residential mortgage lending throughout the United States. Securities Holdings is a holding company that provides, through its subsidiaries, investment banking and other related financial services, including municipal advisory, sales, trading and underwriting of taxable and tax-exempt fixed income securities, clearing, securities lending, structured finance and retail brokerage services throughout the United States. Unless otherwise noted, the Company’s notes to the consolidated financial statements present information limited to continuing operations.

As a result of the spread of the novel coronavirus (“COVID-19”) pandemic, economic uncertainties have contributed to significant volatility in the global economy, as well as banking and other financial activity in the areas in which the Company operates. The effects of COVID-19 have had, and may continue to have, an adverse effect on the financial markets and overall economic conditions on an unprecedented scale. The Company’s business is dependent upon the willingness and ability of its employees and customers to conduct banking and other financial transactions. The rapid development and fluidity of this situation precludes any prediction as to the ultimate adverse impact of COVID-19. COVID-19 presents material uncertainty which could have a material adverse effect on the Company’s business, financial condition, results of operations and cash flows.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States (“GAAP”), and in conformity with the rules and regulations of the Securities and Exchange Commission (the “SEC”). In the opinion of management, these financial statements contain all adjustments necessary for a fair statement of the results of the interim periods presented. Accordingly, the financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2020 (“2020 Form 10-K”). Results for interim periods are not necessarily indicative of results to be expected for a full year or any future period.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates regarding the allowance for credit losses, the fair values of financial instruments, the mortgage loan indemnification liability, and the potential impairment of goodwill and identifiable intangible assets are particularly subject to change. The Company has applied its critical accounting policies and estimation methods consistently in all periods presented in these consolidated financial statements. Actual amounts

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

and values as of the balance sheet dates may be materially different than the amounts and values reported due to the inherent uncertainty in the estimation process. Also, future amounts and values could differ materially from those estimates due to changes in values and circumstances after the balance sheet date.

Hilltop owns 100% of the outstanding stock of PCC. PCC owns 100% of the outstanding stock of the Bank and 100% of the membership interest in Hilltop Opportunity Partners LLC, a merchant bank utilized to facilitate investments in companies engaged in non-financial activities. The Bank owns 100% of the outstanding stock of PrimeLending, a PlainsCapital Company (“PrimeLending”).

PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC (“Ventures Management”), which holds an ownership interest in and is the managing member of certain affiliated business arrangements (“ABAs”).

PCC also owned 100% of the outstanding common securities of PCC Statutory Trusts I, II, III and IV (the “Trusts”), which were not included in the consolidated financial statements under the requirements of the Variable Interest Entities (“VIE”) Subsections of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) because the primary beneficiaries of the Trusts are not within the consolidated group. Following receipt of regulatory approval, during June, July and August 2021, PCC submitted to the trustees of each of the Trusts notices to redeem in full outstanding junior subordinated debentures of \$67.0 million issued by PCC, which resulted in the full redemption to the holders of the associated preferred securities and common securities during the third quarter of 2021.

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

In addition, Hilltop owns 100% of the membership interest in each of HTH Hillcrest Project LLC (“HTH Project LLC”) and Hilltop Investments I, LLC. Hilltop Investments I, LLC owns 50% of the membership interest in HTH Diamond Hillcrest Land LLC (“Hillcrest Land LLC”) which is consolidated under the aforementioned VIE Subsections of the ASC. These entities are related to the Hilltop Plaza investment discussed in detail in Note 20 to the consolidated financial statements included in the Company’s 2020 Form 10-K and are collectively referred to as the “Hilltop Plaza Entities.”

The consolidated financial statements include the accounts of the above-named entities. Intercompany transactions and balances have been eliminated. Noncontrolling interests have been recorded for minority ownership in entities that are not wholly owned and are presented in compliance with the provisions of Noncontrolling Interest in Subsidiary Subsections of the ASC.

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

Significant accounting policies are detailed in Note 1 to the consolidated financial statements included in the Company’s 2020 Form 10-K.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

2. Recently Issued Accounting Standards

Accounting Standards Adopted During 2021

In January 2020, FASB issued Accounting Standards Update (“ASU”) 2020-01 to clarify the interaction among ASC 321, ASC 323, and ASC 815 for equity securities, equity method investments, and certain financial instruments to acquire equity securities. ASU 2020-01 clarifies whether re-measurement of equity investments is appropriate when observable transactions cause the equity method to be triggered or discontinued. ASU 2020-01 also provides that certain forward contracts and purchased options to acquire equity securities will be measured under ASC 321 without an assessment of subsequent accounting upon settlement or exercise. The amendment is effective in periods beginning after December 15, 2020. The Company adopted the provisions of this amendment as of January 1, 2021. The adoption of these provisions did not have a material impact on its consolidated financial statements.

In July 2021, FASB issued ASU 2021-05, which amends ASC 842 to require lessors to classify leases as operating leases if they have variable lease payments that do not depend on an index or rate and would have selling losses if they were classified as sales-type or direct financing leases. As permitted within the amendment, the Company elected to early adopt the provisions as of July 31, 2021. The adoption of this amendment did not have a material impact on the Company’s consolidated financial statements.

Accounting Standards Issued But Not Yet Adopted

In August 2021, FASB issued ASU 2021-06 to both clarify and improve disclosures related to depository lending and investment companies. The amendments in ASU 2021-06 are effective for fiscal years beginning after December 15, 2021. The Company is currently evaluating the impact of adoption on its consolidated financial statements, but does not believe the adoption of this amendment will have a material impact on its consolidated financial statements.

3. Discontinued Operations

NLC Sale

On June 30, 2020, Hilltop completed the sale of all of the outstanding capital stock of NLC, which comprised the operations of the insurance segment, for cash proceeds of \$154.1 million. During 2020, Hilltop recognized an aggregate gain associated with this transaction of \$36.8 million, net of customary transaction costs of \$5.1 million and was subject to post-closing adjustments. The resulting book gain from this sale transaction was not recognized for tax purposes due to the excess tax basis over book basis being greater than the recorded book gain. Any tax loss related to this transaction is deemed disallowed pursuant to the rules under the Internal Revenue Code.

During the first quarter of 2020, management determined that the then-pending sale of NLC met the criteria to be presented as discontinued operations. All related notes to the consolidated financial statements for discontinued operations have been included in this note.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

The following table presents the results of discontinued operations for NLC for the periods indicated (in thousands).

	<u>Three Months Ended</u> <u>September 30, 2020</u>	<u>Nine Months Ended</u> <u>September 30, 2020</u>
Interest income:		
Securities:		
Taxable	\$ —	\$ 1,752
Other	—	71
Total interest income	—	1,823
Interest expense:		
Notes payable	—	775
Noninterest income:		
Net insurance premiums earned	—	65,077
Other	—	3,051
Total noninterest income	—	68,128
Noninterest expense:		
Employees' compensation and benefits	—	6,002
Occupancy and equipment, net	—	464
Professional services	—	18,201
Loss and loss adjustment expenses	—	38,419
Other	—	3,987
Total noninterest expense	—	67,073
Income from discontinued operations before income taxes	—	2,103
Gain on disposal of discontinued operations	736	33,077
Income tax expense	—	518
Income from discontinued operations, net of income taxes	<u>\$ 736</u>	<u>\$ 34,662</u>

Reinsurance Activity

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

	<u>Three Months Ended</u> <u>September 30, 2020</u>		<u>Nine Months Ended</u> <u>September 30, 2020</u>	
	<u>Written</u>	<u>Earned</u>	<u>Written</u>	<u>Earned</u>
Premiums from direct business	\$ —	\$ —	\$ 63,811	\$ 61,384
Reinsurance assumed	—	—	6,396	6,452
Reinsurance ceded	—	—	(2,759)	(2,759)
Net premiums	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 67,448</u>	<u>\$ 65,077</u>

The effects of reinsurance on incurred losses and LAE are included within discontinued operations and are as follows (in thousands).

	<u>Three Months Ended</u> <u>September 30, 2020</u>	<u>Nine Months Ended</u> <u>September 30, 2020</u>
Losses and LAE incurred	\$ —	\$ 38,225
Reinsurance recoverables	—	194
Net loss and LAE incurred	<u>\$ —</u>	<u>\$ 38,419</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

4. Fair Value Measurements

Fair Value Measurements and Disclosures

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

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

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

Fair Value Option

The Company has elected to measure substantially all of PrimeLending’s mortgage loans held for sale and the retained mortgage servicing rights (“MSR”) asset at fair value, under the provisions of the Fair Value Option. The Company elected to apply the provisions of the Fair Value Option to these items so that it would have the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. At September 30, 2021 and December 31, 2020, the aggregate fair value of PrimeLending’s mortgage loans held for sale accounted for under the Fair Value Option was \$1.90 billion and \$2.52 billion, respectively, and the unpaid principal balance of those loans was \$1.85 billion and \$2.41 billion, respectively. The interest component of fair value is reported as interest income on loans in the accompanying consolidated statements of operations.

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

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

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

<u>September 30, 2021</u>	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
Trading securities	\$ 8,301	\$ 601,512	\$ —	\$ 609,813
Available for sale securities	—	1,994,183	—	1,994,183
Equity securities	221	—	—	221
Loans held for sale	—	1,828,626	72,519	1,901,145
Derivative assets	—	89,440	—	89,440
MSR asset	—	—	110,931	110,931
Securities sold, not yet purchased	79,725	33,339	—	113,064
Derivative liabilities	—	27,349	—	27,349
<u>December 31, 2020</u>	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
Trading securities	\$ 45,390	\$ 648,865	\$ —	\$ 694,255
Available for sale securities	—	1,462,205	—	1,462,205
Equity securities	140	—	—	140
Loans held for sale	—	2,449,588	71,816	2,521,404
Derivative assets	—	126,898	—	126,898
MSR asset	—	—	143,742	143,742
Securities sold, not yet purchased	54,494	25,295	—	79,789
Derivative liabilities	—	74,598	—	74,598

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

	<u>Balance, Beginning of Period</u>	<u>Purchases/ Additions</u>	<u>Sales/ Reductions</u>	<u>Transfers to (from) Level 3</u>	<u>Total Gains or Losses (Realized or Unrealized)</u>		<u>Balance, End of Period</u>
					<u>Included in Net Income</u>	<u>Included in Other Comprehensive Income (Loss)</u>	
<u>Three months ended September 30, 2021</u>							
Loans held for sale	\$ 71,433	\$ 18,817	\$ (22,207)	\$ (2,291)	\$ 6,767	\$ —	\$ 72,519
MSR asset	124,497	20,252	(31,366)	—	(2,452)	—	110,931
Total	<u>\$ 195,930</u>	<u>\$ 39,069</u>	<u>\$ (53,573)</u>	<u>\$ (2,291)</u>	<u>\$ 4,315</u>	<u>\$ —</u>	<u>\$ 183,450</u>
<u>Nine months ended September 30, 2021</u>							
Loans held for sale	\$ 71,816	\$ 50,273	\$ (51,718)	\$ (4,099)	\$ 6,247	\$ —	\$ 72,519
MSR asset	143,742	70,368	(116,000)	—	12,821	—	110,931
Total	<u>\$ 215,558</u>	<u>\$ 120,641</u>	<u>\$ (167,718)</u>	<u>\$ (4,099)</u>	<u>\$ 19,068</u>	<u>\$ —</u>	<u>\$ 183,450</u>
<u>Three months ended September 30, 2020</u>							
Loans held for sale	\$ 91,936	\$ 5,338	\$ (20,182)	\$ 1,097	\$ (6,003)	\$ —	\$ 72,186
MSR asset	81,264	59,351	—	—	(12,903)	—	127,712
Total	<u>\$ 173,200</u>	<u>\$ 64,689</u>	<u>\$ (20,182)</u>	<u>\$ 1,097</u>	<u>\$ (18,906)</u>	<u>\$ —</u>	<u>\$ 199,898</u>
<u>Nine months ended September 30, 2020</u>							
Loans held for sale	\$ 67,195	\$ 53,961	\$ (51,125)	\$ 10,064	\$ (7,909)	\$ —	\$ 72,186
MSR asset	55,504	123,266	(18,650)	—	(32,408)	—	127,712
Total	<u>\$ 122,699</u>	<u>\$ 177,227</u>	<u>\$ (69,775)</u>	<u>\$ 10,064</u>	<u>\$ (40,317)</u>	<u>\$ —</u>	<u>\$ 199,898</u>

All net realized and unrealized gains (losses) in the tables above are reflected in the accompanying consolidated financial statements. The unrealized gains (losses) relate to financial instruments still held at September 30, 2021.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

For Level 3 financial instruments measured at fair value on a recurring basis at September 30, 2021 and December 31, 2020, the significant unobservable inputs used in the fair value measurements were as follows.

Financial instrument	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)	
			September 30, 2021	December 31, 2020
Loans held for sale.	Market comparable	Projected price	94 - 96 % (96%)	91 - 94 % (94 %)
MSR asset	Discounted cash flows	Constant prepayment rate	10.02 %	12.15 %
		Discount rate	14.31 %	14.60 %

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

The MSR asset is reported at fair value using Level 3 inputs. The MSR asset is valued by projecting net servicing cash flows, which are then discounted to estimate the fair value. The fair value of the MSR asset is impacted by a variety of factors. Prepayment and discount rates, the most significant unobservable inputs, are discussed further in Note 8 to the consolidated financial statements. The decrease in the prepayment rate used to value the MSR asset at September 30, 2021, compared to December 31, 2020, reflects the effect of increased mortgage rates reducing consumer refinancing activity.

The Company had no transfers between Levels 1 and 2 during the periods presented. Any transfers are based on changes in the observability and/or significance of the valuation inputs and are assumed to occur at the beginning of the quarterly reporting period in which they occur.

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

	Three Months Ended September 30, 2021			Three Months Ended September 30, 2020		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale.	\$ (32,694)	\$ —	\$ (32,694)	\$ (9,167)	\$ —	\$ (9,167)
MSR asset	(2,452)	—	(2,452)	(12,903)	—	(12,903)

	Nine Months Ended September 30, 2021			Nine Months Ended September 30, 2020		
	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value	Net Gains (Losses)	Other Noninterest Income	Total Changes in Fair Value
Loans held for sale.	\$ (55,211)	\$ —	\$ (55,211)	\$ 49,311	\$ —	\$ 49,311
MSR asset	12,821	—	12,821	(32,408)	—	(32,408)

The Fair Value of Financial Instruments Subsection of the ASC requires disclosure of the fair value of financial assets and liabilities, including the financial assets and liabilities previously discussed. There have been no changes to the methods for determining estimated fair value for financial assets and liabilities as described in detail in Note 5 to the consolidated financial statements included in the Company's 2020 Form 10-K.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

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

September 30, 2021	Carrying Amount	Estimated Fair Value			Total
		Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	
Financial assets:					
Cash and cash equivalents	\$ 2,463,517	\$ 2,463,517	\$ —	\$ —	\$ 2,463,517
Assets segregated for regulatory purposes	269,506	269,506	—	—	269,506
Securities purchased under agreements to resell	155,908	—	155,908	—	155,908
Held to maturity securities	277,419	—	288,112	—	288,112
Loans held for sale	207,733	—	207,733	—	207,733
Loans held for investment, net	7,443,414	—	645,901	7,084,518	7,730,419
Broker-dealer and clearing organization receivables	1,419,652	—	1,419,652	—	1,419,652
Other assets	71,464	—	69,938	1,526	71,464
Financial liabilities:					
Deposits	12,132,162	—	12,137,502	—	12,137,502
Broker-dealer and clearing organization payables	1,496,923	—	1,496,923	—	1,496,923
Short-term borrowings	747,040	—	747,040	—	747,040
Debt	395,804	—	395,804	—	395,804
Other liabilities	10,099	—	10,099	—	10,099

December 31, 2020	Carrying Amount	Estimated Fair Value			Total
		Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	
Financial assets:					
Cash and cash equivalents	\$ 1,062,946	\$ 1,062,946	\$ —	\$ —	\$ 1,062,946
Assets segregated for regulatory purposes	290,357	290,357	—	—	290,357
Securities purchased under agreements to resell	80,319	—	80,319	—	80,319
Held to maturity securities	311,944	—	326,671	—	326,671
Loans held for sale	266,982	—	266,982	—	266,982
Loans held for investment, net	7,544,097	—	437,007	7,351,411	7,788,418
Broker-dealer and clearing organization receivables	1,404,727	—	1,404,727	—	1,404,727
Other assets	74,881	—	73,111	1,770	74,881
Financial liabilities:					
Deposits	11,242,319	—	11,256,629	—	11,256,629
Broker-dealer and clearing organization payables	1,368,373	—	1,368,373	—	1,368,373
Short-term borrowings	695,798	—	695,798	—	695,798
Debt	448,999	—	448,999	—	448,999
Other liabilities	6,133	—	6,133	—	6,133

The Company held equity investments other than securities of \$53.9 million and \$63.6 million at September 30, 2021 and December 31, 2020, respectively, which are included within other assets in the consolidated balance sheets. Of the \$53.9 million of such equity investments held at September 30, 2021, \$16.5 million do not have readily determinable fair values and each is measured at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. The following table presents the adjustments to the carrying value of these investments during the periods presented (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Balance, beginning of period	\$ 26,988	\$ 20,613	\$ 22,844	\$ 19,771
Upward adjustments	122	2,221	6,006	3,852
Impairments and downward adjustments	(253)	(826)	(1,017)	(1,615)
Dispositions	(10,390)	—	(11,366)	—
Balance, end of period	\$ 16,467	\$ 22,008	\$ 16,467	\$ 22,008

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

5. Securities

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

	September 30, 2021	December 31, 2020
U.S. Treasury securities	\$ 3,401	\$ 40,491
U.S. government agencies:		
Bonds	14,883	40
Residential mortgage-backed securities	196,241	336,081
Commercial mortgage-backed securities	—	876
Collateralized mortgage obligations	54,065	69,172
Corporate debt securities	72,029	62,481
States and political subdivisions	264,044	171,573
Private-label securitized product	177	8,571
Other	4,973	4,970
Totals	<u>\$ 609,813</u>	<u>\$ 694,255</u>

In addition to the securities shown above, the Hilltop Broker-Dealers enter into transactions that represent commitments to purchase and deliver securities at prevailing future market prices to facilitate customer transactions and satisfy such commitments. Accordingly, the Hilltop Broker-Dealers' ultimate obligations may exceed the amount recognized in the financial statements. These securities, which are carried at fair value and reported as securities sold, not yet purchased in the consolidated balance sheets, had a value of \$113.1 million and \$79.8 million at September 30, 2021 and December 31, 2020, respectively.

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

	Available for Sale			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2021				
U.S. Treasury securities	\$ 4,972	\$ —	\$ (16)	\$ 4,956
U.S. government agencies:				
Bonds	45,181	1,010	(72)	46,119
Residential mortgage-backed securities	901,720	10,784	(8,247)	904,257
Commercial mortgage-backed securities	205,290	476	(8,129)	197,637
Collateralized mortgage obligations	794,258	3,992	(4,241)	794,009
States and political subdivisions	45,574	1,887	(256)	47,205
Totals	<u>\$ 1,996,995</u>	<u>\$ 18,149</u>	<u>\$ (20,961)</u>	<u>\$ 1,994,183</u>
	Available for Sale			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2020				
U.S. government agencies:				
Bonds	\$ 82,036	\$ 1,095	\$ (325)	\$ 82,806
Residential mortgage-backed securities	624,863	17,194	(446)	641,611
Commercial mortgage-backed securities	124,929	768	(1,159)	124,538
Collateralized mortgage obligations	559,362	6,916	(370)	565,908
States and political subdivisions	44,729	2,613	—	47,342
Totals	<u>\$ 1,435,919</u>	<u>\$ 28,586</u>	<u>\$ (2,300)</u>	<u>\$ 1,462,205</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

September 30, 2021	Held to Maturity			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government agencies:				
Residential mortgage-backed securities	\$ 10,755	\$ 518	\$ —	\$ 11,273
Commercial mortgage-backed securities	150,060	6,727	—	156,787
Collateralized mortgage obligations	48,210	1,070	—	49,280
States and political subdivisions	68,394	2,402	(24)	70,772
Totals	\$ 277,419	\$ 10,717	\$ (24)	\$ 288,112

December 31, 2020	Held to Maturity			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government agencies:				
Residential mortgage-backed securities	\$ 13,547	\$ 708	\$ —	\$ 14,255
Commercial mortgage-backed securities	152,820	9,205	—	162,025
Collateralized mortgage obligations	74,932	2,036	—	76,968
States and political subdivisions	70,645	2,778	—	73,423
Totals	\$ 311,944	\$ 14,727	\$ —	\$ 326,671

Additionally, the Company had unrealized net gains of \$0.2 and \$0.1 million at September 30, 2021 and December 31, 2020, respectively, from equity securities with fair values of \$0.2 million and \$0.1 million held at September 30, 2021 and December 31, 2020, respectively. The Company recognized nominal net gains and net losses during the three and nine months ended September 30, 2021 and 2020, respectively, due to changes in the fair value of equity securities still held at the balance sheet date. During the three and nine months ended September 30, 2021 and 2020, net gains recognized from equity securities sold were nominal.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

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

	September 30, 2021			December 31, 2020		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Available for Sale						
U.S. treasury securities:						
Unrealized loss for less than twelve months	1	\$ 4,956	\$ 16	—	\$ —	\$ —
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	1	4,956	16	—	—	—
U.S. government agencies:						
Bonds:						
Unrealized loss for less than twelve months	1	4,985	15	8	60,298	325
Unrealized loss for twelve months or longer	1	6,389	57	—	—	—
	2	11,374	72	8	60,298	325
Residential mortgage-backed securities:						
Unrealized loss for less than twelve months	58	608,502	7,983	15	86,287	429
Unrealized loss for twelve months or longer	5	27,357	264	—	—	—
	63	635,859	8,247	15	86,287	429
Commercial mortgage-backed securities:						
Unrealized loss for less than twelve months	11	132,020	4,765	10	105,386	1,176
Unrealized loss for twelve months or longer	7	59,021	3,364	—	—	—
	18	191,041	8,129	10	105,386	1,176
Collateralized mortgage obligations:						
Unrealized loss for less than twelve months	39	363,054	3,943	10	101,990	324
Unrealized loss for twelve months or longer	7	46,686	298	5	13,611	46
	46	409,740	4,241	15	115,601	370
States and political subdivisions:						
Unrealized loss for less than twelve months	25	8,993	256	—	—	—
Unrealized loss for twelve months or longer	—	—	—	—	—	—
	25	8,993	256	—	—	—
Total available for sale:						
Unrealized loss for less than twelve months	135	1,122,510	16,978	43	353,961	2,254
Unrealized loss for twelve months or longer	20	139,453	3,983	5	13,611	46
	155	\$ 1,261,963	\$ 20,961	48	\$ 367,572	\$ 2,300
	September 30, 2021			December 31, 2020		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
Held to Maturity						
States and political subdivisions:						
Unrealized loss for less than twelve months	6	\$ 1,831	\$ 21	2	\$ 578	\$ —
Unrealized loss for twelve months or longer	1	264	3	—	—	—
	7	2,095	24	2	578	—
Total held to maturity:						
Unrealized loss for less than twelve months	6	1,831	21	2	578	—
Unrealized loss for twelve months or longer	1	264	3	—	—	—
	7	\$ 2,095	\$ 24	2	\$ 578	\$ —

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The amortized cost and fair value of securities, excluding trading and equity securities, at September 30, 2021 are shown by contractual maturity below (in thousands).

	Available for Sale		Held to Maturity	
	Amortized		Amortized	
	Cost	Fair Value	Cost	Fair Value
Due in one year or less	\$ 2,025	\$ 2,053	\$ 667	\$ 682
Due after one year through five years	36,055	37,118	1,179	1,199
Due after five years through ten years	15,487	16,096	14,094	14,643
Due after ten years	42,160	43,013	52,454	54,248
	95,727	98,280	68,394	70,772
Residential mortgage-backed securities	901,720	904,257	10,755	11,273
Collateralized mortgage obligations	794,258	794,009	48,210	49,280
Commercial mortgage-backed securities	205,290	197,637	150,060	156,787
	\$ 1,996,995	\$ 1,994,183	\$ 277,419	\$ 288,112

The Company recognized net gains of \$2.0 million and \$86.2 million from its trading portfolio during the three months ended September 30, 2021 and 2020, respectively, and \$21.8 million and \$106.7 million during the nine months ended September 30, 2021 and 2020, respectively. In addition, the Hilltop Broker-Dealers realized net gains from structured product trading activities of \$17.0 million and net losses from structured product trading activities of \$14.4 million during the three months ended September 30, 2021 and 2020, respectively, and net gains from structured product trading activities of \$52.1 million and \$27.8 million during the nine months ended September 30, 2021 and 2020, respectively. The Company had nominal other realized gains on securities during the three months ended September 30, 2021 and 2020, respectively. Other realized losses on securities during the nine months ended September 30, 2021 were \$0.1 million, compared with other realized gains on securities of \$0.2 million during the nine months ended September 30, 2020. All such realized gains and losses are recorded as a component of other noninterest income within the consolidated statements of operations.

Securities with a carrying amount of \$704.1 million and \$712.3 million (with a fair value of \$718.3 million and \$733.8 million, respectively) at September 30, 2021 and December 31, 2020, respectively, were pledged by the Bank to secure public and trust deposits, federal funds purchased and securities sold under agreements to repurchase, and for other purposes as required or permitted by law. Substantially all of these pledged securities were included in the available for sale and held to maturity securities portfolios at September 30, 2021 and December 31, 2020.

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

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

6. Loans Held for Investment

The Bank originates loans to customers primarily in Texas. Although the Bank has diversified loan and leasing portfolios and, generally, holds collateral against amounts advanced to customers, its debtors' ability to honor their contracts is substantially dependent upon the general economic conditions of the region and of the industries in which its debtors operate, which consist primarily of agribusiness, construction, energy, real estate and wholesale/retail trade. The Hilltop Broker-Dealers make loans to customers and correspondents through transactions originated by both employees and independent retail representatives throughout the United States. The Hilltop Broker-Dealers control risk by requiring customers to maintain collateral in compliance with various regulatory and internal guidelines, which may vary based upon market conditions. Securities owned by customers and held as collateral for loans are not included in the consolidated financial statements.

Loans held for investment summarized by portfolio segment are as follows (in thousands).

	September 30, 2021	December 31, 2020
Commercial real estate	\$ 3,032,141	\$ 3,133,903
Commercial and industrial ⁽¹⁾	1,950,797	2,627,774
Construction and land development	789,693	828,852
1-4 family residential	1,104,847	629,938
Consumer	29,547	35,667
Broker-dealer ⁽²⁾	645,901	437,007
	<u>7,552,926</u>	<u>7,693,141</u>
Allowance for credit losses	<u>(109,512)</u>	<u>(149,044)</u>
Total loans held for investment, net of allowance	<u>\$ 7,443,414</u>	<u>\$ 7,544,097</u>

- (1) Included loans totaling \$133.2 million and \$486.7 million at September 30, 2021 and December 31, 2020, respectively, funded through the Paycheck Protection Program.
(2) Primarily represents margin loans to customers and correspondents associated with broker-dealer segment operations.

The following table provides details associated with non-accrual loans, excluding those classified as held for sale (in thousands).

	Non-accrual Loans						Interest Income Recognized			
	September 30, 2021			December 31, 2020			Three Months Ended September 30,		Nine Months Ended September 30,	
	With Allowance	With No Allowance	Total	With Allowance	With No Allowance	Total	2021	2020	2021	2020
Commercial real estate:										
Non-owner occupied	\$ 417	\$ 900	\$ 1,317	\$ 1,213	\$ 445	\$ 1,658	\$ 76	\$ 99	\$ 204	\$ 88
Owner occupied	3,071	1,317	4,388	3,473	6,002	9,475	345	156	574	241
Commercial and industrial	21,291	8,517	29,808	10,821	23,228	34,049	179	312	653	714
Construction and land development	2	364	366	102	405	507	13	36	48	89
1-4 family residential	1,432	18,476	19,908	4,726	16,651	21,377	796	134	2,837	1,299
Consumer	24	—	24	28	—	28	1	2	(120)	(1)
Broker-dealer	—	—	—	—	—	—	—	—	—	—
	<u>\$ 26,237</u>	<u>\$ 29,574</u>	<u>\$ 55,811</u>	<u>\$ 20,363</u>	<u>\$ 46,731</u>	<u>\$ 67,094</u>	<u>\$ 1,410</u>	<u>\$ 739</u>	<u>\$ 4,196</u>	<u>\$ 2,430</u>

At September 30, 2021 and December 31, 2020, \$5.3 million and \$10.9 million, respectively, of real estate loans secured by residential properties and classified as held for sale were in non-accrual status.

Loans accounted for on a non-accrual basis decreased \$11.3 million from December 31, 2020 to September 30, 2021, primarily due to decreases in commercial real estate owner occupied loans of \$5.1 million, commercial and industrial loans of \$4.2 million, and 1-4 family residential loans of \$1.5 million. The respective decreases in commercial real estate owner occupied loans and commercial and industrial loans in non-accrual status since December 31, 2020 were primarily due to principal paydowns associated with five relationships.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

The Company considers non-accrual loans to be collateral-dependent unless there are underlying mitigating circumstances. The practical expedient to measure the allowance using the fair value of the collateral has been implemented.

The Bank classifies loan modifications as troubled debt restructurings (“TDRs”) when it concludes that it has both granted a concession to a debtor and that the debtor is experiencing financial difficulties. Loan modifications are typically structured to create affordable payments for the debtor and can be achieved in a variety of ways. The Bank modifies loans by reducing interest rates and/or lengthening loan amortization schedules. The Bank may also reconfigure a single loan into two or more loans (“A/B Note”). The typical A/B Note restructure results in a “bad” loan which is charged off and a “good” loan or loans, the terms of which comply with the Bank’s customary underwriting policies. The debt charged off on the “bad” loan is not forgiven to the debtor.

In March 2020, the CARES Act was passed, which, among other things, allows the Bank to suspend the requirements for certain loan modifications to be categorized as a TDR, including the related impairment for accounting purposes. On December 27, 2020, the Consolidated Appropriations Act 2021 was signed into law. Section 541 of this legislation, “Extension of Temporary Relief From Troubled Debt Restructurings and Insurer Clarification,” extends certain relief provisions from the March CARES Act that were set to expire at the end of 2020. This new legislation extends the relief to financial institutions to suspend TDR assessment and reporting requirements under GAAP for loan modifications to the earlier of 60 days after the national emergency termination date or January 1, 2022. The Bank’s COVID-19 payment deferral programs allow for a deferral of principal and/or interest payments with such deferred principal payments due and payable on maturity date of the existing loan. The Bank’s actions included approval of approximately \$1.0 billion in COVID-19 related loan modifications as of December 31, 2020. During 2021, the Bank continued to support its impacted banking clients through the approval of COVID-19 related loan modifications, which resulted in an additional \$15 million of new COVID-19 related loan modifications since December 31, 2020. The portfolio of active deferrals that have not reached the end of their deferral period was approximately \$17 million as of September 30, 2021. While the majority of the portfolio of COVID-19 related loan modifications no longer require deferral, such loans may represent elevated risk, and therefore management continues to monitor these loans. The extent to which these measures will impact the Bank remains uncertain, and any progression of loans, whether receiving COVID-19 payment deferrals or not, into non-accrual status during future periods is uncertain and will depend on future developments that cannot be predicted.

During the three months ended September 30, 2021 there were no TDRs granted that do not qualify for the CARES Act exemption, while there was one TDR granted during the nine months ended September 30, 2021 with an aggregate balance at date of extension and at September 30, 2021 of \$0.7 million that does not qualify for the CARES Act exemption. During the three months ended September 30, 2020 there were no TDRs granted, while there were two TDRs granted during the nine months ended September 30, 2020 with an aggregate balance at date of extension of \$7.8 million and an aggregate balance at September 30, 2020 of \$3.2 million. The Bank had no unadvanced commitments to borrowers whose loans had been restructured in TDRs at September 30, 2021 and nominal commitments to such borrowers at December 31, 2020. There were \$0.1 million TDRs granted during the twelve months preceding September 30, 2021, while there were no TDRs granted during the twelve months preceding September 30, 2020, for which a payment was at least 30 days past due.

An analysis of the aging of the Company’s loan portfolio is shown in the following tables (in thousands).

<u>September 30, 2021</u>	<u>Loans Past Due 30-59 Days</u>	<u>Loans Past Due 60-89 Days</u>	<u>Loans Past Due 90 Days or More</u>	<u>Total Past Due Loans</u>	<u>Current Loans</u>	<u>Total Loans</u>	<u>Accruing Loans Past Due 90 Days or More</u>
Commercial real estate:							
Non-owner occupied	\$ 1,621	\$ —	\$ 199	\$ 1,820	\$ 1,722,798	\$ 1,724,618	\$ —
Owner occupied	149	—	2,274	2,423	1,305,100	1,307,523	—
Commercial and industrial	603	632	13,936	15,171	1,935,626	1,950,797	1
Construction and land development	10	77	—	87	789,606	789,693	—
1-4 family residential	4,009	1,676	7,021	12,706	1,092,141	1,104,847	88
Consumer	154	3	23	180	29,367	29,547	—
Broker-dealer	—	—	—	—	645,901	645,901	—
	<u>\$ 6,546</u>	<u>\$ 2,388</u>	<u>\$ 23,453</u>	<u>\$ 32,387</u>	<u>\$ 7,520,539</u>	<u>\$ 7,552,926</u>	<u>\$ 89</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

<u>December 31, 2020</u>	<u>Loans Past Due 30-59 Days</u>	<u>Loans Past Due 60-89 Days</u>	<u>Loans Past Due 90 Days or More</u>	<u>Total Past Due Loans</u>	<u>Current Loans</u>	<u>Total Loans</u>	<u>Accruing Loans Past Due 90 Days or More</u>
Commercial real estate:							
Non-owner occupied	\$ 1,919	\$ —	\$ 199	\$ 2,118	\$ 1,786,193	\$ 1,788,311	\$ —
Owner occupied	195	522	8,328	9,045	1,336,547	1,345,592	—
Commercial and industrial	3,114	407	7,318	10,839	2,616,935	2,627,774	6
Construction and land development	19	—	—	19	828,833	828,852	—
1-4 family residential	8,110	3,040	12,420	23,570	606,368	629,938	—
Consumer	172	123	26	321	35,346	35,667	—
Broker-dealer	—	—	—	—	437,007	437,007	—
	<u>\$ 13,529</u>	<u>\$ 4,092</u>	<u>\$ 28,291</u>	<u>\$ 45,912</u>	<u>\$ 7,647,229</u>	<u>\$ 7,693,141</u>	<u>\$ 6</u>

In addition to the loans shown in the tables above, PrimeLending had \$175.6 million and \$243.6 million of loans included in loans held for sale (with an aggregate unpaid principal balance of \$177.2 million and \$245.5 million, respectively) that were 90 days past due and accruing interest at September 30, 2021 and December 31, 2020, respectively. These loans are guaranteed by U.S. government agencies and include loans that are subject to repurchase, or have been repurchased, by PrimeLending.

In response to the COVID-19 pandemic, the Company allowed modifications, such as payment deferrals for up to 90 days and temporary forbearance, to credit-worthy borrowers who are experiencing temporary hardship due to the effects of COVID-19. These short-term modifications generally meet the criteria of the CARES Act and, therefore, they are not reported as past due or placed on non-accrual status (provided the loans were not past due or on non-accrual status prior to the deferral). The Company elected to accrue and recognize interest income on these modifications during the payment deferral period.

Additionally, the Company granted temporary forbearance to borrowers of a federally backed mortgage loan experiencing financial hardship due, directly or indirectly, to the COVID-19 pandemic. The CARES Act, which among other things, established the ability for financial institutions to grant a forbearance for up to 180 days, which can be extended for an additional 180-day period upon the request of the borrower. During that time, no fees, penalties or interest beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the mortgage contract will accrue on the borrower's account. As of September 30, 2021, PrimeLending had \$99.5 million of loans subject to repurchase under a forbearance agreement related to delinquencies on or after April 1, 2020.

Management tracks credit quality trends on a quarterly basis related to: (i) past due levels, (ii) non-performing asset levels, (iii) classified loan levels, and (iv) general economic conditions in state and local markets. The Company defines classified loans as loans with a risk rating of substandard, doubtful or loss. There have been no changes to the risk rating internal grades utilized for commercial loans as described in detail in Note 7 to the consolidated financial statements in the Company's 2020 Form 10-K.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

The following table presents loans held for investment grouped by asset class and credit quality indicator, segregated by year of origination or renewal (in thousands).

September 30, 2021	Amortized Cost Basis by Origination Year					2016 and		Total
	2021	2020	2019	2018	2017	Prior	Revolving	
Commercial real estate: non-owner occupied								
Internal Grade 1-3 (Pass low risk)	\$ 17,984	\$ 14,856	\$ 24,145	\$ 9,102	\$ 1,379	\$ 19,704	\$ (4)	\$ 87,166
Internal Grade 4-7 (Pass normal risk)	235,408	207,049	113,457	50,614	42,473	68,139	33,405	750,545
Internal Grade 8-11 (Pass high risk and watch)	92,225	226,326	128,586	96,780	56,898	142,747	1,219	744,781
Internal Grade 12 (Special mention)	—	—	3,167	1,210	—	3,423	—	7,800
Internal Grade 13 (Substandard accrual)	24,370	8,995	16,142	16,866	17,809	48,727	100	133,009
Internal Grade 14 (Substandard non-accrual)	417	—	—	—	—	900	—	1,317
Commercial real estate: owner occupied								
Internal Grade 1-3 (Pass low risk)	\$ 116,722	\$ 64,383	\$ 17,413	\$ 29,476	\$ 32,386	\$ 37,852	\$ 4	\$ 298,236
Internal Grade 4-7 (Pass normal risk)	149,531	123,342	120,207	89,486	27,442	83,316	15,191	608,515
Internal Grade 8-11 (Pass high risk and watch)	49,084	107,022	44,373	83,934	20,594	34,431	7,888	347,326
Internal Grade 12 (Special mention)	—	—	—	—	—	—	—	—
Internal Grade 13 (Substandard accrual)	576	14,642	5,331	7,691	6,828	13,990	—	49,058
Internal Grade 14 (Substandard non-accrual)	1,602	—	(3)	350	2,271	168	—	4,388
Commercial and industrial								
Internal Grade 1-3 (Pass low risk)	\$ 20,215	\$ 32,018	\$ 26,301	\$ 7,741	\$ 8,963	\$ 2,655	\$ 58,993	\$ 156,886
Internal Grade 4-7 (Pass normal risk)	87,493	100,455	31,496	25,226	15,217	16,710	275,095	551,692
Internal Grade 8-11 (Pass high risk and watch)	84,927	87,955	39,591	15,075	7,662	7,076	292,171	534,457
Internal Grade 12 (Special mention)	—	23	—	—	—	—	2,106	2,129
Internal Grade 13 (Substandard accrual)	2,250	10,839	1,471	7,280	4,212	3,875	6,699	36,626
Internal Grade 14 (Substandard non-accrual)	6,619	17,977	511	1,772	225	87	2,617	29,808
Construction and land development								
Internal Grade 1-3 (Pass low risk)	\$ 15,898	\$ 27,992	\$ 5,166	\$ 3,746	\$ 241	\$ 4,078	\$ 1,450	\$ 58,571
Internal Grade 4-7 (Pass normal risk)	212,531	170,416	39,782	11,603	1,982	3,310	25,021	464,645
Internal Grade 8-11 (Pass high risk and watch)	91,197	75,871	48,342	1,125	469	1,945	22,608	241,557
Internal Grade 12 (Special mention)	—	—	—	—	—	—	—	—
Internal Grade 13 (Substandard accrual)	—	—	28	—	5,347	—	—	5,375
Internal Grade 14 (Substandard non-accrual)	381	—	—	—	—	(15)	—	366
Construction and land development - individuals								
FICO less than 620	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
FICO between 620 and 720	944	287	—	1,226	—	—	—	2,457
FICO greater than 720	10,396	5,744	—	—	—	—	—	16,140
Substandard non-accrual	—	—	—	—	—	—	—	—
Other ⁽¹⁾	582	—	—	—	—	—	—	582
1-4 family residential								
FICO less than 620	\$ 472	\$ 1,556	\$ 722	\$ 3,632	\$ 53	\$ 26,855	\$ 255	\$ 33,545
FICO between 620 and 720	14,627	12,452	8,093	7,748	7,196	35,937	911	86,964
FICO greater than 720	561,557	140,097	60,302	34,483	19,508	59,801	3,757	879,505
Substandard non-accrual	—	14	1,063	273	122	18,436	—	19,908
Other ⁽¹⁾	58,137	9,604	8,406	4,821	790	2,300	867	84,925
Consumer								
FICO less than 620	\$ 967	\$ 577	\$ 437	\$ 55	\$ 74	\$ 50	\$ 346	\$ 2,506
FICO between 620 and 720	3,478	1,811	976	188	444	78	1,887	8,862
FICO greater than 720	4,066	3,088	979	468	58	18	3,385	12,062
Substandard non-accrual	—	—	—	—	23	1	—	24
Other ⁽¹⁾	3,891	1,349	416	41	14	27	355	6,093
Total loans with credit quality measures	\$ 1,868,547	\$ 1,466,740	\$ 746,900	\$ 512,012	\$ 280,680	\$ 636,621	\$ 756,326	\$ 6,267,826
Commercial and industrial (mortgage warehouse lending)								\$ 505,976
Commercial and industrial (Paycheck Protection Program loans)								\$ 133,223
Broker-Dealer (margin loans and correspondent receivables)								\$ 645,901
Total loans held for investment								\$ 7,552,926

(1) Loans classified in this category were assigned a FICO score based on various factors specific to the borrower for credit modeling purposes.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

7. Allowance for Credit Losses

Available for Sale Securities and Held to Maturity Securities

The Company has evaluated available for sale debt securities that are in an unrealized loss position and has determined that any decline in value is unrelated to credit loss and related to changes in market interest rates since purchase. None of the available for sale debt securities held were past due at September 30, 2021. In addition, as of September 30, 2021, the Company had not made a decision to sell any of its debt securities held, nor did the Company consider it more likely than not that it would be required to sell such securities before recovery of their amortized cost basis. The Company does not expect to have credit losses associated with the debt securities and no allowance was recognized on the debt securities portfolio at transition.

Loans Held for Investment

The allowance for credit losses for loans held for investment represents management's best estimate of all expected credit losses over the expected contractual life of our existing portfolio. Management revised its methodology for determining the allowance for credit losses upon the implementation of the current expected credit losses ("CECL") standard. Management considers the level of allowance for credit losses to be a reasonable and supportable estimate of expected credit losses inherent within the loans held for investment portfolio as of September 30, 2021. While the Company believes it has an appropriate allowance for the existing loan portfolio at September 30, 2021, additional provision for losses on existing loans may be necessary in the future. Future changes in the allowance for credit losses are expected to be volatile given dependence upon, among other things, the portfolio composition and quality, as well as the impact of significant drivers, including prepayment assumptions and macroeconomic conditions and forecasts. In addition to the allowance for credit losses, the Company maintains a separate allowance for credit losses related to off-balance sheet credit exposures, including unfunded loan commitments, and this amount is included in other liabilities within the consolidated balance sheets. For further information on the policies that govern the estimation of the allowances for credit losses levels, see Note 1 to the consolidated financial statements in the Company's 2020 Form 10-K.

One of the most significant judgments involved in estimating the Company's allowance for credit losses relates to the macroeconomic forecasts used to estimate credit losses over the reasonable and supportable forecast period. To determine our best estimate of expected credit losses as of September 30, 2021, the Company utilized a single macroeconomic alternative baseline, or S7, scenario published by Moody's Analytics in September 2021 that was updated to reflect the U.S. economic outlook. This alternative baseline scenario reflects the initial continuing recovery of the economy, as in the baseline scenario published by Moody's Analytics, in addition to the risk of acceleration of inflation followed by a Federal Reserve policy response that would tighten credit and cause the economy to fall into recession. Significant variables that impact the modeled losses across our loan portfolios are the U.S. Real Gross Domestic Product, or GDP, growth rates and unemployment rate assumptions. Changes in these assumptions and forecasts of economic conditions could significantly affect the estimate of expected credit losses at the balance sheet date or between reporting periods.

The COVID-19 pandemic disrupted financial markets and overall economic conditions that have affected borrowers across our lending portfolios. Significant judgment is required to estimate the severity and duration of the current economic uncertainties, as well as its potential impact on borrower defaults and loss severity. In particular, macroeconomic conditions and forecasts are rapidly changing and remain highly uncertain as COVID-19 cases and vaccine effectiveness, as well as government stimulus and policy measures, evolve nationally and in key geographies.

During the first quarter of 2020, the Company adopted the new CECL standard and recorded transition adjustment entries that resulted in an allowance for credit losses of \$73.7 million as of January 1, 2020, an increase of \$12.6 million. This increase included an increase in credit losses of \$18.9 million from the expansion of the loss horizon to life of loan, partially offset by the elimination of the non-credit component within the historical allowance related to previously categorized PCI loans of \$6.3 million.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

During the three months ended September 30, 2020, the allowance included a net reversal of credit losses on individually evaluated loans of \$1.2 million, while the provision for credit losses on expected losses of collectively evaluated loans accounted for \$0.6 million of the total provision primarily due to the identified changes in the Bank's loan portfolio composition and credit quality being offset by improvements in macroeconomic factor assumptions and qualitative factors from the prior quarter. The change in the allowance during the three months ended September 30, 2020 was also impacted by net charge-offs of \$0.6 million. During the nine months ended September 30, 2020, the significant build in the allowance included provision for credit losses on individually evaluated loans of \$22.6 million, while the provision for credit losses on expected losses of collectively evaluated loans accounted for \$77.2 million of the total provision primarily due to the increase in the expected lifetime credit losses under CECL attributable to the deteriorating economic outlook associated with the impact of the market disruption caused by the COVID-19 pandemic. The changes in the allowance for credit losses during the noted periods were also attributable to other factors including, but not limited to, loan growth and loan mix. The change in the allowance during the nine months ended September 30, 2020 was also impacted by net charge-offs of \$18.5 million, primarily associated with loans specifically reserved for during the first quarter of 2020.

During the three and nine months ended September 30, 2021, the decreases in the allowance reflect improvement in both realized economic results and the macroeconomic outlook and were significantly comprised of net reversals of credit losses on expected losses of collectively evaluated loans of \$11.0 million and \$45.2 million, respectively. Such reversals were primarily due to improvements in both macroeconomic forecast assumptions and credit quality metrics on COVID-19 impacted industry sector exposures. The net impact to the allowance of changes associated with individually evaluated loans during the three and nine months ended September 30, 2021 included a provision for credit losses of \$5.2 million and \$5.6 million, respectively. The changes in the allowance for credit losses during the noted periods were primarily attributable to the Bank and also reflected other factors including, but not limited to, loan mix, and changes in loan balances and qualitative factors from the prior quarter. The changes in the allowance during both the three and nine months ended September 30, 2021 were also impacted by net recoveries of \$0.1 million.

Changes in the allowance for credit losses for loans held for investment, distributed by portfolio segment, are shown below (in thousands).

	Balance, Beginning of Period	Transition Adjustment CECL	Provision for (Reversal of) Credit Losses	Loans Charged Off	Recoveries on Charged Off Loans	Balance, End of Period
Three Months Ended September 30, 2021						
Commercial real estate	\$ 77,633	\$ —	\$ (8,993)	\$ (124)	\$ 19	\$ 68,535
Commercial and industrial	27,866	—	2,398	(317)	598	30,545
Construction and land development	5,185	—	(85)	—	—	5,100
1-4 family residential	3,659	—	946	(87)	20	4,538
Consumer	592	—	(41)	(73)	26	504
Broker-dealer	334	—	(44)	—	—	290
Total	<u>\$ 115,269</u>	<u>\$ —</u>	<u>\$ (5,819)</u>	<u>\$ (601)</u>	<u>\$ 663</u>	<u>\$ 109,512</u>
Nine Months Ended September 30, 2021						
Commercial real estate	\$ 109,629	\$ —	\$ (41,037)	\$ (310)	\$ 253	\$ 68,535
Commercial and industrial	27,703	—	2,848	(1,738)	1,732	30,545
Construction and land development	6,677	—	(1,577)	—	—	5,100
1-4 family residential	3,946	—	358	(248)	482	4,538
Consumer	876	—	(317)	(226)	171	504
Broker-dealer	213	—	77	—	—	290
Total	<u>\$ 149,044</u>	<u>\$ —</u>	<u>\$ (39,648)</u>	<u>\$ (2,522)</u>	<u>\$ 2,638</u>	<u>\$ 109,512</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Three Months Ended September 30, 2020	Balance, Beginning of Period	Transition Adjustment CECL	Provision for (Reversal of) Credit Losses	Loans Charged Off	Recoveries on Charged Off Loans	Balance, End of Period
Commercial real estate	\$ 106,551	\$ —	\$ (2,527)	\$ (29)	\$ 571	\$ 104,566
Commercial and industrial	31,863	—	7,274	(1,341)	382	38,178
Construction and land development	8,393	—	(2,123)	—	—	6,270
1-4 family residential	7,399	—	(2,213)	(144)	10	5,052
Consumer	1,429	—	(411)	(100)	84	1,002
Broker-dealer	748	—	(602)	—	—	146
Total	<u>\$ 156,383</u>	<u>\$ —</u>	<u>\$ (602)</u>	<u>\$ (1,614)</u>	<u>\$ 1,047</u>	<u>\$ 155,214</u>

Nine Months Ended September 30, 2020	Balance, Beginning of Period	Transition Adjustment CECL	Provision for (Reversal of) Credit Losses	Loans Charged Off	Recoveries on Charged Off Loans	Balance, End of Period
Commercial real estate	\$ 31,595	\$ 8,073	\$ 68,823	\$ (4,517)	\$ 592	\$ 104,566
Commercial and industrial	17,964	3,193	30,896	(15,325)	1,450	38,178
Construction and land development	4,878	577	815	(2)	2	6,270
1-4 family residential	6,386	(29)	(813)	(517)	25	5,052
Consumer	265	748	154	(473)	308	1,002
Broker-dealer	48	—	98	—	—	146
Total	<u>\$ 61,136</u>	<u>\$ 12,562</u>	<u>\$ 99,973</u>	<u>\$ (20,834)</u>	<u>\$ 2,377</u>	<u>\$ 155,214</u>

Unfunded Loan Commitments

The Bank uses a process similar to that used in estimating the allowance for credit losses on the funded portion to estimate the allowance for credit loss on unfunded loan commitments. The allowance is based on the estimated exposure at default, multiplied by the lifetime Probability of Default grade and Loss Given Default grade for that particular loan segment. The Bank estimates expected losses by calculating a commitment usage factor based on industry usage factors. The commitment usage factor is applied over the relevant contractual period. Loss factors from the underlying loans to which commitments are related are applied to the results of the usage calculation to estimate any liability for credit losses related for each loan type. The expected losses on unfunded commitments align with statistically calculated parameters used to calculate the allowance for credit losses on the funded portion. There is no reserve calculated for letters of credit as they are issued primarily as credit enhancements and the likelihood of funding is low.

Changes in the allowance for credit losses for loans with off-balance sheet credit exposures are shown below (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Balance, beginning of period	\$ 7,981	\$ 9,031	\$ 8,388	\$ 2,075
Transition adjustment CECL accounting standard	—	—	—	3,837
Other noninterest expense	(1,183)	287	(1,590)	3,406
Balance, end of period	<u>\$ 6,798</u>	<u>\$ 9,318</u>	<u>\$ 6,798</u>	<u>\$ 9,318</u>

As previously discussed, the Company adopted the new CECL standard and recorded a transition adjustment entry that resulted in an allowance for credit losses of \$5.9 million as of January 1, 2020. During the three and nine months ended September 30, 2020, the increase in the reserve for unfunded commitments was primarily due to the macroeconomic uncertainties associated with the impact of the market disruption caused by COVID-19 conditions. During the three and nine months ended September 30, 2021, the decreases in the reserve for unfunded commitments were primarily due to improvements in loan expected loss rates.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

8. Mortgage Servicing Rights

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

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Balance, beginning of period	\$ 124,497	\$ 81,264	\$ 143,742	\$ 55,504
Additions	20,252	59,351	70,368	123,266
Sales	(31,366)	—	(116,000)	(18,650)
Changes in fair value:				
Due to changes in model inputs or assumptions ⁽¹⁾	3,525	(10,145)	32,199	(26,023)
Due to customer payoffs	(5,977)	(2,758)	(19,378)	(6,385)
Balance, end of period	<u>\$ 110,931</u>	<u>\$ 127,712</u>	<u>\$ 110,931</u>	<u>\$ 127,712</u>
			<u>September 30,</u>	<u>December 31,</u>
			<u>2021</u>	<u>2020</u>
Mortgage loans serviced for others ⁽²⁾			\$ 8,672,818	\$ 14,643,623
MSR asset as a percentage of serviced mortgage loans			1.28 %	0.98 %

(1) Primarily represents normal customer payments, changes in discount rates and prepayment speed assumptions, which are primarily affected by changes in interest rates and the refinement of other MSR model assumptions. Included in the three and nine months ended September 30, 2021 are MSR asset fair value adjustments totaling \$3.3 million and \$22.2 million, respectively, which reflect the difference between the MSR asset carrying values and the sale prices reflected in the letters of intent to sell the applicable MSR assets.

(2) Represents unpaid principal balance of mortgage loans serviced for others.

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

	<u>September 30,</u>	<u>December 31,</u>
	<u>2021</u>	<u>2020</u>
Weighted average constant prepayment rate	10.02 %	12.15 %
Weighted average discount rate	14.31 %	14.60 %
Weighted average life (in years)	7.1	6.3

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

	<u>September 30,</u>	<u>December 31,</u>
	<u>2021</u>	<u>2020</u>
Constant prepayment rate:		
Impact of 10% adverse change	\$ (2,467)	\$ (5,639)
Impact of 20% adverse change	(5,043)	(11,164)
Discount rate:		
Impact of 10% adverse change	(3,885)	(6,435)
Impact of 20% adverse change	(7,399)	(12,287)

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

Contractually specified servicing fees, late fees and ancillary fees earned of \$15.6 million and \$10.3 million during the three months ended September 30, 2021 and 2020, respectively, and \$47.9 million and \$21.3 million during the nine months ended September 30, 2021 and 2020, respectively, were included in net gains from sale of loans and other mortgage production income within the consolidated statements of operations.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

9. Deposits

Deposits are summarized as follows (in thousands).

	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Noninterest-bearing demand	\$ 4,433,148	\$ 3,612,384
Interest-bearing:		
Demand accounts	2,906,009	2,399,341
Brokered - demand	104,796	282,426
Money market	3,132,456	2,716,878
Brokered - money market	108,196	124,243
Savings	306,755	276,327
Time	1,110,325	1,506,435
Brokered - time	30,477	324,285
	<u>\$ 12,132,162</u>	<u>\$ 11,242,319</u>

10. Short-term Borrowings

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

	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Federal funds purchased	\$ 159,825	\$ 180,325
Securities sold under agreements to repurchase	155,294	237,856
Federal Home Loan Bank	—	—
Short-term bank loans	64,000	—
Commercial paper	367,921	277,617
	<u>\$ 747,040</u>	<u>\$ 695,798</u>

Federal Funds Purchased and Securities Sold under Agreements to Repurchase

Federal funds purchased and securities sold under agreements to repurchase generally mature daily, on demand, or on some other short-term basis. The Bank and the Hilltop Broker-Dealers execute transactions to sell securities under agreements to repurchase with both customers and other broker-dealers. Securities involved in these transactions are held by the Bank, the Hilltop Broker-Dealers or a third-party dealer.

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

	<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>
Average balance during the period	\$ 328,853	\$ 547,925
Average interest rate during the period	0.37 %	1.03 %
	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Average interest rate at end of period	0.29 %	0.25 %
Securities underlying the agreements at end of period:		
Carrying value	\$ 156,402	\$ 237,913
Estimated fair value	\$ 172,111	\$ 262,554

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Federal Home Loan Bank (“FHLB”)

FHLB short-term borrowings mature over terms not exceeding 365 days and are collateralized by FHLB Dallas stock, nonspecified real estate loans and certain specific commercial real estate loans. Other information regarding FHLB short-term borrowings is shown in the following table (dollars in thousands).

	Nine Months Ended September 30,	
	2021	2020
Average balance during the period	\$ —	\$ 51,606
Average interest rate during the period	— %	1.62 %

Short-Term Bank Loans

The Hilltop Broker-Dealers use short-term bank loans periodically to finance securities owned, margin loans to customers and correspondents and underwriting activities. Interest on the borrowings varies with the federal funds rate. The weighted average interest rate on the borrowings at September 30, 2021 was 1.25%.

Commercial Paper

Hilltop Securities uses the net proceeds (after deducting related issuance expenses) from the sale of two commercial paper programs for general corporate purposes, including working capital and the funding of a portion of its securities inventories. The commercial paper notes (“CP Notes”) may be issued with maturities of 14 days to 270 days from the date of issuance. The CP Notes are issued under two separate programs, Series 2019-1 CP Notes and Series 2019-2 CP Notes, in maximum aggregate amounts of \$300 million and \$200 million, respectively. The CP Notes are not redeemable prior to maturity or subject to voluntary prepayment and do not bear interest, but are sold at a discount to par. The CP Notes are secured by a pledge of collateral owned by Hilltop Securities. As of September 30, 2021, the weighted average maturity of the CP Notes was 159 days at a rate of 1.06%, with a weighted average remaining life of 85 days. At September 30, 2021, the aggregate amount outstanding under these secured arrangements was \$367.9 million, which was collateralized by securities held for firm accounts valued at \$400.5 million.

11. Notes Payable

Notes payable consisted of the following (in thousands).

	September 30, 2021	December 31, 2020
Senior Notes due April 2025, net of discount of \$931 and \$1,063, respectively	\$ 149,069	\$ 148,937
Subordinated Notes due May 2030, net of discount of \$727 and \$793, respectively.	49,273	49,207
Subordinated Notes due May 2035, net of discount of \$2,264 and \$2,392, respectively . .	147,736	147,608
Ventures Management lines of credit	49,726	36,235
	\$ 395,804	\$ 381,987

12. Leases

Supplemental balance sheet information related to finance leases is as follows (in thousands).

	September 30, 2021	December 31, 2020
Finance leases:		
Premises and equipment	\$ 7,780	\$ 7,780
Accumulated depreciation	(5,210)	(4,768)
Premises and equipment, net	\$ 2,570	\$ 3,012

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

The components of lease costs, including short-term lease costs, are as follows (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Operating lease cost	\$ 9,727	\$ 11,067	\$ 29,130	\$ 32,318
Less operating lease and sublease income	(343)	(363)	(1,024)	(1,336)
Net operating lease cost	<u>\$ 9,384</u>	<u>\$ 10,704</u>	<u>\$ 28,106</u>	<u>\$ 30,982</u>
Finance lease cost:				
Amortization of ROU assets	\$ 147	\$ 147	\$ 442	\$ 442
Interest on lease liabilities	129	139	396	424
Total finance lease cost	<u>\$ 276</u>	<u>\$ 286</u>	<u>\$ 838</u>	<u>\$ 866</u>

Supplemental cash flow information related to leases is as follows (in thousands).

	Nine Months Ended September 30,	
	2021	2020
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 28,160	\$ 27,994
Operating cash flows from finance leases	396	424
Financing cash flows from finance leases	509	472
Right-of-use assets obtained in exchange for lease obligations:		
Operating leases	\$ 37,086	\$ 8,773
Finance leases	—	—

Information regarding the lease terms and discount rates of the Company's leases is as follows.

<u>Lease Classification</u>	<u>September 30, 2021</u>		<u>December 31, 2020</u>	
	<u>Weighted Average Remaining Lease Term (Years)</u>	<u>Weighted Average Discount Rate</u>	<u>Weighted Average Remaining Lease Term (Years)</u>	<u>Weighted Average Discount Rate</u>
	Operating	6.0	4.01 %	5.5
Finance	5.0	4.83 %	5.6	4.81 %

Future minimum lease payments under lease agreements as of September 30, 2021, are presented below (in thousands).

	<u>Operating Leases</u>	<u>Finance Leases</u>
2021	\$ 444	\$ 307
2022	33,994	1,241
2023	29,196	1,280
2024	21,068	1,163
2025	15,669	886
Thereafter	<u>51,163</u>	<u>1,411</u>
Total minimum lease payments	151,534	6,288
Less amount representing interest	(17,238)	(1,938)
Lease liabilities	<u>\$ 134,296</u>	<u>\$ 4,350</u>

As of September 30, 2021, the Company had additional operating leases that have not yet commenced with aggregate future minimum lease payments of approximately \$1.6 million. These operating leases are expected to commence between October 2021 and December 2021 with lease terms ranging from three to six years.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

13. Income Taxes

The Company applies an estimated annual effective rate to interim period pre-tax income to calculate the income tax provision for the quarter in accordance with the principal method prescribed by the accounting guidance established for computing income taxes in interim periods. The Company's effective tax rates from continuing operations were 22.8% and 22.7% for the three months ended September 30, 2021 and 2020, respectively, and 23.2% and 23.0% for the nine months ended September 30, 2021 and 2020, respectively, and approximated the applicable statutory rates for such periods.

14. Commitments and Contingencies

Legal Matters

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

Assessments of litigation and claims exposures are difficult due to many factors that involve inherent unpredictability. Those factors include the following: the varying stages of the proceedings, particularly in the early stages; unspecified, unsupported, or uncertain damages; damages other than compensatory, such as punitive damages; a matter presenting meaningful legal uncertainties, including novel issues of law; multiple defendants and jurisdictions; whether discovery has begun or is complete; whether meaningful settlement discussions have commenced; and whether the claim involves a class action and if so, how the class is defined. As a result of some of these factors, the Company may be unable to estimate reasonably possible losses with respect to some or all of the pending and threatened litigation and claims asserted against the Company.

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

PrimeLending received an investigative inquiry from the United States Attorney for the Western District of Virginia regarding PrimeLending's float down option. At this time, the United States Attorney has requested certain materials with respect to this matter, and PrimeLending is fully cooperating with such requests.

While the final outcome of litigation and claims exposures or of any Inquiries is inherently unpredictable, management is currently of the opinion that the outcome of pending and threatened litigation and inquiries will not, except related to specific matters disclosed above, have a material effect on the Company's business, consolidated financial position,

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

results of operations or cash flows as a whole. However, in the event of unexpected future developments, it is reasonably possible that an adverse outcome in any matter, including the matters discussed above, could be material to the Company's business, consolidated financial position, results of operations or cash flows for any particular reporting period of occurrence.

Indemnification Liability Reserve

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

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

An additional reserve has been established for probable agency, investor or other party losses that may have been incurred, but not yet reported to the mortgage origination segment based upon a reasonable estimate of such losses. Factors considered in the calculation of this reserve include, but are not limited to, the total volume of loans sold exclusive of specific claimant requests, actual claim settlements and the severity of estimated losses resulting from future claims, and the mortgage origination segment's history of successfully curing defects identified in claim requests. In addition, the mortgage origination segment has considered that GNMA, FNMA and FHLMC have imposed certain restrictions on loans the agencies will accept under a forbearance agreement resulting from the COVID-19 pandemic, which could increase the magnitude of indemnification losses on these loans.

While the mortgage origination segment's sales contracts typically include borrower early payment default repurchase provisions, these provisions have not been a primary driver of claims to date, and therefore, are not a primary factor considered in the calculation of this reserve.

At September 30, 2021 and December 31, 2020, the mortgage origination segment's indemnification liability reserve totaled \$26.0 million and \$21.5 million, respectively. The provision for indemnification losses was \$2.5 million and \$3.1 million during the three months ended September 30, 2021 and 2020, respectively, and \$8.0 million and \$7.7 million during the nine months ended September 30, 2021 and 2020, respectively.

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

	Representation and Warranty Specific Claims			
	Activity - Origination Loan Balance			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Balance, beginning of period	\$ 32,763	\$ 35,194	\$ 30,085	\$ 32,144
Claims made	5,412	2,558	19,100	14,770
Claims resolved with no payment	(4,217)	(45)	(9,088)	(1,702)
Repurchases	(3,981)	(1,582)	(9,238)	(8,965)
Indemnification payments	(267)	—	(1,149)	(122)
Balance, end of period	<u>\$ 29,710</u>	<u>\$ 36,125</u>	<u>\$ 29,710</u>	<u>\$ 36,125</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

	Indemnification Liability Reserve Activity			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Balance, beginning of period	\$ 26,372	\$ 15,463	\$ 21,531	\$ 11,776
Additions for new sales	2,702	3,066	8,568	6,688
Repurchases	(2,687)	(133)	(3,086)	(613)
Early payment defaults	(116)	(413)	(152)	(815)
Indemnification payments	(78)	—	(342)	(40)
Change in reserves for loans sold in prior years	(220)	—	(546)	987
Balance, end of period	<u>\$ 25,973</u>	<u>\$ 17,983</u>	<u>\$ 25,973</u>	<u>\$ 17,983</u>
	September 30,	December 31,		
	2021	2020		
Reserve for Indemnification Liability:				
Specific claims	\$ 196	\$ 961		
Incurred but not reported claims	25,777	20,570		
Total	<u>\$ 25,973</u>	<u>\$ 21,531</u>		

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

15. Financial Instruments with Off-Balance Sheet Risk

Banking

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

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

In the aggregate, the Bank had outstanding unused commitments to extend credit of \$2.1 billion at September 30, 2021 and outstanding financial and performance standby letters of credit of \$87.2 million at September 30, 2021.

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

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Broker-Dealer

In the normal course of business, the Hilltop Broker-Dealers execute, settle, and finance various securities transactions that may expose the Hilltop Broker-Dealers to off-balance sheet risk in the event that a customer or counterparty does not fulfill its contractual obligations. Examples of such transactions include the sale of securities not yet purchased by customers or for the accounts of the Hilltop Broker-Dealers, use of derivatives to support certain non-profit housing organization clients and to hedge changes in the fair value of certain securities, clearing agreements between the Hilltop Broker-Dealers and various clearinghouses and broker-dealers, secured financing arrangements that involve pledged securities, and when-issued underwriting and purchase commitments.

16. Stock-Based Compensation

Since 2012, the Company has issued stock-based incentive awards pursuant to the Hilltop Holdings Inc. 2012 Equity Incentive Plan (the “2012 Plan”). In July 2020, pursuant to stockholders’ approval, the Company adopted the Hilltop Holdings Inc. 2020 Equity Incentive Plan (the “2020 Plan”). The 2020 Plan serves as successor to the 2012 Plan. The 2012 Plan and the 2020 Plan are referred to collectively as “the Equity Plans.”

During the nine months ended September 30, 2021 and 2020, Hilltop granted 12,957 and 25,817 shares of common stock, respectively, pursuant to the Equity Plans to certain non-employee members of the Company’s board of directors for services rendered to the Company.

Restricted Stock Units

The following table summarizes information about nonvested restricted stock unit (“RSU”) activity for the nine months ended September 30, 2021 (shares in thousands).

	RSUs	
Outstanding		Weighted Average Grant Date Fair Value
Balance, December 31, 2020	1,833	\$ 21.48
Granted	532	\$ 32.93
Vested/Released	(473)	\$ 27.65
Forfeited	(17)	\$ 22.51
Balance, September 30, 2021	1,875	\$ 23.17

Vested/Released RSUs include an aggregate of 78,432 shares withheld to satisfy employee statutory tax obligations during the nine months ended September 30, 2021.

During the nine months ended September 30, 2021, the Compensation Committee of the board of directors of the Company awarded certain executives and key employees an aggregate of 471,505 RSUs pursuant to the Equity Plans. Of the RSUs granted during the nine months ended September 30, 2021, 318,387 that were outstanding at September 30, 2021, are subject to time-based vesting conditions and generally cliff vest on the third anniversary of the grant date. Of the RSUs granted during the nine months ended September 30, 2021, 150,668 that were outstanding at September 30, 2021, provide for cliff vesting based upon the achievement of certain performance goals over a three-year period.

At September 30, 2021, in the aggregate, 1,510,530 of the outstanding RSUs are subject to time-based vesting conditions and generally cliff vest on the third anniversary of the grant date, and 364,149 outstanding RSUs cliff vest based upon the achievement of certain performance goals over a three-year period. At September 30, 2021, unrecognized compensation expense related to outstanding RSUs of \$24.4 million is expected to be recognized over a weighted average period of 1.40 years.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

17. Regulatory Matters

Banking and Hilltop

PlainsCapital, which includes the Bank and PrimeLending, and Hilltop are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory — and possibly additional discretionary — actions by regulators that, if undertaken, could have a direct, material effect on the consolidated financial statements. The regulations require PlainsCapital and Hilltop to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company performs reviews of the classification and calculation of risk-weighted assets to ensure accuracy and compliance with the Basel III regulatory capital requirements as implemented by the Board of Governors of the Federal Reserve System. The capital classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Quantitative measures established by regulation to ensure capital adequacy require the companies to maintain minimum amounts and ratios (set forth in the following table) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of common equity Tier 1, Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

In order to avoid limitations on capital distributions, including dividend payments, stock repurchases and certain discretionary bonus payments to executive officers, Basel III requires banking organizations to maintain a capital conservation buffer above minimum risk-based capital requirements measured relative to risk-weighted assets.

The following table shows PlainsCapital’s and Hilltop’s actual capital amounts and ratios in accordance with Basel III compared to the regulatory minimum capital requirements including conservation buffer ratio in effect at the end of the period (dollars in thousands). Based on actual capital amounts and ratios shown in the following table, PlainsCapital’s ratios place it in the “well capitalized” (as defined) capital category under regulatory requirements. Actual capital amounts and ratios as of September 30, 2021 reflect PlainsCapital’s and Hilltop’s decision to elect the transition option as issued by the federal banking regulatory agencies in March 2020 that permits banking institutions to mitigate the estimated cumulative regulatory capital effects from CECL over a five-year transitional period.

	<u>September 30, 2021</u>		<u>December 31, 2020</u>		<u>Minimum Capital Requirements Including Conservation Buffer Ratio</u>	<u>To Be Well Capitalized Ratio</u>
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>		
Tier 1 capital (to average assets):						
PlainsCapital	\$ 1,398,761	10.02 %	\$ 1,385,842	10.44 %	4.0 %	5.0 %
Hilltop	2,209,309	12.64 %	2,111,580	12.64 %	4.0 %	N/A
Common equity Tier 1 capital (to risk-weighted assets):						
PlainsCapital	1,398,761	15.40 %	1,385,842	14.40 %	7.0 %	6.5 %
Hilltop	2,209,309	21.28 %	2,046,580	18.97 %	7.0 %	N/A
Tier 1 capital (to risk-weighted assets):						
PlainsCapital	1,398,761	15.40 %	1,385,842	14.40 %	8.5 %	8.0 %
Hilltop	2,209,309	21.28 %	2,111,580	19.57 %	8.5 %	N/A
Total capital (to risk-weighted assets):						
PlainsCapital	1,482,471	16.32 %	1,470,364	15.27 %	10.5 %	10.0 %
Hilltop	2,492,353	24.00 %	2,409,684	22.34 %	10.5 %	N/A

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Broker-Dealer

Pursuant to the net capital requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), Hilltop Securities has elected to determine its net capital requirements using the alternative method. Accordingly, Hilltop Securities is required to maintain minimum net capital, as defined in Rule 15c3-1 promulgated under the Exchange Act, equal to the greater of \$1,000,000 or 2% of aggregate debit balances, as defined in Rule 15c3-3 promulgated under the Exchange Act. Additionally, the net capital rule of the NYSE provides that equity capital may not be withdrawn or cash dividends paid if resulting net capital would be less than 5% of the aggregate debit items. Momentum Independent Network follows the primary (aggregate indebtedness) method, as defined in Rule 15c3-1 promulgated under the Exchange Act, which requires the maintenance of the larger of \$250,000 or 6-2/3% of aggregate indebtedness.

At September 30, 2021, the net capital position of each of the Hilltop Broker-Dealers was as follows (in thousands).

	Hilltop Securities	Momentum Independent Network
Net capital	\$ 228,135	\$ 4,111
Less: required net capital	11,249	283
Excess net capital	\$ 216,886	\$ 3,828
Net capital as a percentage of aggregate debit items	40.6 %	
Net capital in excess of 5% aggregate debit items	\$ 200,012	

Under certain conditions, Hilltop Securities may be required to segregate cash and securities in a special reserve account for the benefit of customers under Rule 15c3-3 promulgated under the Exchange Act. Assets segregated for regulatory purposes under the provisions of the Exchange Act are restricted and not available for general corporate purposes. At September 30, 2021 and December 31, 2020, the Hilltop Broker-Dealers held cash of \$269.5 million and \$290.4 million, respectively, segregated in special reserve bank accounts for the benefit of customers. The Hilltop Broker-Dealers were not required to segregate cash and securities in special reserve accounts for the benefit of proprietary accounts of introducing broker-dealers at September 30, 2021 or December 31, 2020.

Mortgage Origination

As a mortgage originator, PrimeLending and its subsidiaries are subject to minimum net worth and liquidity requirements established by HUD and GNMA, as applicable. On an annual basis, PrimeLending and its subsidiaries submit audited financial statements to HUD and GNMA, as applicable, documenting their respective compliance with minimum net worth and liquidity requirements. As of September 30, 2021, PrimeLending and its subsidiaries’ net worth and liquidity exceeded the amounts required by both HUD and GNMA, as applicable.

18. Stockholders’ Equity

Dividends

During the nine months ended September 30, 2021 and 2020, the Company declared and paid cash dividends of \$0.36 and \$0.27 per common share, or an aggregate of \$29.5 million and \$24.4 million, respectively.

On October 28, 2021, Hilltop’s board of directors declared a quarterly cash dividend of \$0.12 per common share, payable on November 30, 2021, to all common stockholders of record as of the close of business on November 15, 2021.

Stock Repurchases

In January 2021, the Hilltop board of directors authorized a new stock repurchase program through January 2022, pursuant to which the Company was originally authorized to repurchase, in the aggregate, up to \$75.0 million of its outstanding common stock. In July 2021, the Hilltop board of directors authorized an increase to the aggregate amount

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

of common stock the Company may repurchase under this program by \$75.0 million to \$150.0 million. Then, in October 2021, the Hilltop board of directors authorized, subject to regulatory review, an increase to the aggregate amount of common stock the Company may repurchase under this program by \$50.0 million to \$200.0 million, which is inclusive of repurchases to offset dilution related to grants of stock-based compensation.

During the nine months ended September 30, 2021, the Company paid \$123.6 million to repurchase an aggregate of 3,632,482 shares of common stock at a weighted average price of \$34.01 per share. The Company's stock repurchase program, prior year repurchases and related accounting policy are discussed in detail in Note 1 and Note 25 to the consolidated financial statements included in the Company's 2020 Form 10-K.

19. Derivative Financial Instruments

The Company uses various derivative financial instruments to mitigate interest rate risk. The Bank's interest rate risk management strategy involves effectively managing the re-pricing characteristics of certain assets and liabilities to mitigate potential adverse impacts from changes in interest rates on the Bank's net interest margin. Additionally, the Bank manages variability of cash flows associated with its variable rate debt in interest-related cash outflows with interest rate swap contracts. PrimeLending has interest rate risk relative to interest rate lock commitments ("IRLCs") and its inventory of mortgage loans held for sale. PrimeLending is exposed to such interest rate risk from the time an IRLC is made to an applicant to the time the related mortgage loan is sold. To mitigate interest rate risk, PrimeLending executes forward commitments to sell mortgage-backed securities ("MBSs") and Eurodollar futures. Additionally, PrimeLending has interest rate risk relative to its MSR asset and uses derivative instruments, including interest rate swaps and U.S. Treasury bond futures and options to hedge this risk. The Hilltop Broker-Dealers use forward commitments to both purchase and sell MBSs to facilitate customer transactions and as a means to hedge related exposure to interest rate risk in certain inventory positions. Additionally, Hilltop Securities uses various derivative instruments, including U.S. Treasury bond futures and options, Eurodollar futures and municipal market data, or MMD, rate locks, to hedge changes in the fair value of its securities.

Non-Hedging Derivative Instruments and the Fair Value Option

As discussed in Note 4 to the consolidated financial statements, the Company has elected to measure substantially all mortgage loans held for sale at fair value under the provisions of the Fair Value Option. The election provides the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without applying hedge accounting provisions. The fair values of PrimeLending's IRLCs and forward commitments are recorded in other assets or other liabilities, as appropriate, and changes in the fair values of these derivative instruments are recorded as a component of net gains from sale of loans and other mortgage production income. These changes in fair value are attributable to changes in the volume of IRLCs, mortgage loans held for sale, commitments to purchase and sell MBSs and MSR assets, and changes in market interest rates. Changes in market interest rates also conversely affect the value of PrimeLending's mortgage loans held for sale and its MSR asset, which are measured at fair value under the Fair Value Option. The effect of the change in market interest rates on PrimeLending's loans held for sale and MSR asset is discussed in Note 8 to the consolidated financial statements. The fair values of the Hilltop Broker-Dealers' and the Bank's derivative instruments are recorded in other assets or other liabilities, as appropriate. Changes in the fair value of derivatives are presented in the following table (in thousands).

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Increase (decrease) in fair value of derivatives during period:				
PrimeLending	\$ 780	\$ 23,286	\$ 555	\$ 90,429
Hilltop Broker-Dealers	11,427	(3,542)	(3,845)	8,466
Bank	7	118	26	(17)

Hedging Derivative Instruments

The Company has entered into interest rate swap contracts to manage the exposure to changes in fair value associated with certain available for sale fixed rate collateralized mortgage backed securities and fixed rate loans held for investment attributable to changes in the designated benchmark interest rate. Certain of these fair value hedges have

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

been designated as a last-of-layer hedge, which provides the Company the ability to execute a fair value hedge of the interest rate risk associated with a portfolio of similar prepayable assets whereby the last dollar amount estimated to remain in the portfolio of assets is identified as the hedged item. Additionally, the Company has outstanding interest rate swap contracts designated as cash flow hedges and utilized to manage the variability of cash flows associated with its variable rate borrowings.

Under each of its interest rate swap contracts designated as hedges, the Company receives a floating rate and pays a fixed rate on the outstanding notional amount. The Company assesses the hedge effectiveness both at the onset of the hedge and at regular intervals throughout the life of the derivative. To the extent that the derivative instruments are highly effective in offsetting the variability of the hedged cash flows or fair value, changes in the fair value of the derivative are included as a component of other comprehensive loss on our consolidated balance sheets. Although the Company has determined at the onset of the hedges that the derivative instruments will be highly effective hedges throughout the term of the contract, any portion of derivative instruments subsequently determined to be ineffective will be recognized in earnings.

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

	September 30, 2021		December 31, 2020	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Derivative instruments (not designated as hedges):				
IRLCs	\$ 2,061,068	\$ 40,279	\$ 2,470,013	\$ 76,048
Commitments to purchase MBSs	1,759,435	4,745	2,478,041	22,311
Commitments to sell MBSs	4,646,594	14,703	6,141,079	(40,621)
Interest rate swaps	60,245	27	43,786	(2,196)
U.S. Treasury bond futures and options ⁽¹⁾	215,600	—	225,400	—
Eurodollar and other futures ⁽¹⁾	1,182,000	—	—	—
Derivative instruments (designated as hedges):				
Interest rate swaps designated as cash flow hedges	\$ 150,000	\$ (812)	\$ 105,000	\$ (3,112)
Interest rate swaps designated as fair value hedges ⁽²⁾	172,751	3,149	60,618	(130)

(1) Changes in the fair value of these contracts are settled daily with the respective counterparties of PrimeLending and the Hilltop Broker-Dealers.

(2) The Company designated \$172.8 million and \$60.6 million as the hedged amount (from a closed portfolio of prepayable available for sale securities and loans held for investment with a carrying value of \$169.6 million and \$60.7 million as of September 30, 2021 and December 31, 2020, respectively), of which, a subset of these hedges are in last-of-layer hedging relationships. The cumulative basis adjustment included in the carrying value of the hedged items totaled \$3.2 million and \$0.1 million as of September 30, 2021 and December 31, 2020, respectively.

The decrease in the estimated fair value of the IRLCs at September 30, 2021, compared to December 31, 2020, was driven by a decrease in the total volume of IRLCs in addition to a decrease in the average value of individual IRLCs. The decrease in the average value of individual IRLCs was due to an increase in mortgage interest rates throughout the nine months ended September 30, 2021.

PrimeLending held no cash collateral advances, in other liabilities within the consolidated balance sheets, to offset net asset derivative positions on its commitments to sell MBSs at September 30, 2021. PrimeLending had advanced cash collateral totaling \$26.1 million to offset net liability positions on its commitments to sell MBSs at December 31, 2020. In addition, PrimeLending and the Hilltop Broker-Dealers had advanced cash collateral totaling \$0.7 million and \$2.7 million on various derivative instruments at September 30, 2021 and December 31, 2020, respectively. The advanced cash collateral amounts are included in other assets within the consolidated balance sheets.

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

20. Balance Sheet Offsetting

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

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		Net Amount
				Financial Instruments	Cash Collateral Pledged	
September 30, 2021						
Securities borrowed:						
Institutional counterparties.	\$ 1,377,261	\$ —	\$ 1,377,261	\$ (1,318,830)	\$ —	\$ 58,431
Interest rate swaps:						
Institutional counterparties.	73	—	73	(73)	—	—
Reverse repurchase agreements:						
Institutional counterparties.	155,908	—	155,908	(155,908)	—	—
Forward MBS derivatives:						
Institutional counterparties.	20,650	(1,198)	19,452	(11,079)	—	8,373
	<u>\$ 1,553,892</u>	<u>\$ (1,198)</u>	<u>\$ 1,552,694</u>	<u>\$ (1,485,890)</u>	<u>\$ —</u>	<u>\$ 66,804</u>

December 31, 2020						
Securities borrowed:						
Institutional counterparties.	\$ 1,338,855	\$ —	\$ 1,338,855	\$ (1,273,955)	\$ —	\$ 64,900
Reverse repurchase agreements:						
Institutional counterparties.	80,319	—	80,319	(79,925)	—	394
Forward MBS derivatives:						
Institutional counterparties.	22,311	—	22,311	(22,311)	—	—
	<u>\$ 1,441,485</u>	<u>\$ —</u>	<u>\$ 1,441,485</u>	<u>\$ (1,376,191)</u>	<u>\$ —</u>	<u>\$ 65,294</u>

	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Balance Sheet	Net Amounts of Liabilities Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		Net Amount
				Financial Instruments	Cash Collateral Pledged	
September 30, 2021						
Securities loaned:						
Institutional counterparties.	\$ 1,350,722	\$ —	\$ 1,350,722	\$ (1,283,622)	\$ —	\$ 67,100
Interest rate swaps:						
Institutional counterparties.	46	—	46	—	—	46
Repurchase agreements:						
Institutional counterparties.	155,237	—	155,237	(145,564)	—	9,673
Forward MBS derivatives:						
Institutional counterparties.	4	—	4	(4)	—	—
	<u>\$ 1,506,009</u>	<u>\$ —</u>	<u>\$ 1,506,009</u>	<u>\$ (1,429,190)</u>	<u>\$ —</u>	<u>\$ 76,819</u>

December 31, 2020						
Securities loaned:						
Institutional counterparties.	\$ 1,245,066	\$ —	\$ 1,245,066	\$ (1,179,090)	\$ —	\$ 65,976
Interest rate swaps:						
Institutional counterparties.	2,196	—	2,196	(2,123)	—	73
Repurchase agreements:						
Institutional counterparties.	237,856	—	237,856	(237,856)	—	—
Forward MBS derivatives:						
Institutional counterparties.	40,741	(120)	40,621	(12,670)	—	27,951
	<u>\$ 1,525,859</u>	<u>\$ (120)</u>	<u>\$ 1,525,739</u>	<u>\$ (1,431,739)</u>	<u>\$ —</u>	<u>\$ 94,000</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Secured Borrowing Arrangements

Secured Borrowings (Repurchase Agreements) — The Company participates in transactions involving securities sold under repurchase agreements, which are secured borrowings and generally mature one to ninety days from the transaction date or involve arrangements with no definite termination date. Securities sold under repurchase agreements are reflected at the amount of cash received in connection with the transactions. The Company may be required to provide additional collateral based on the fair value of the underlying securities, which is monitored on a daily basis.

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

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

The following tables present the remaining contractual maturities of repurchase agreement and securities lending transactions accounted for as secured borrowings (in thousands). The Company had no repurchase-to-maturity transactions outstanding at both September 30, 2021 and December 31, 2020.

	Remaining Contractual Maturities				
	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
September 30, 2021					
Repurchase agreement transactions:					
U.S. Treasury and agency securities	\$ —	\$ 10,000	\$ —	\$ —	\$ 10,000
Asset-backed securities	41,551	21,781	81,905	—	145,237
Securities lending transactions:					
Corporate securities	113	—	—	—	113
Equity securities	1,350,609	—	—	—	1,350,609
Total	<u>\$ 1,392,273</u>	<u>\$ 31,781</u>	<u>\$ 81,905</u>	<u>\$ —</u>	<u>\$ 1,505,959</u>
Gross amount of recognized liabilities for repurchase agreement and securities lending transactions in offsetting disclosure above					<u>\$ 1,505,959</u>
Amount related to agreements not included in offsetting disclosure above					<u>\$ —</u>

	Remaining Contractual Maturities				
	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
December 31, 2020					
Repurchase agreement transactions:					
Asset-backed securities	\$ 110,831	\$ —	\$ 127,025	\$ —	\$ 237,856
Securities lending transactions:					
Corporate securities	113	—	—	—	113
Equity securities	1,244,953	—	—	—	1,244,953
Total	<u>\$ 1,355,897</u>	<u>\$ —</u>	<u>\$ 127,025</u>	<u>\$ —</u>	<u>\$ 1,482,922</u>
Gross amount of recognized liabilities for repurchase agreement and securities lending transactions in offsetting disclosure above					<u>\$ 1,482,922</u>
Amount related to agreements not included in offsetting disclosure above					<u>\$ —</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

21. Broker-Dealer and Clearing Organization Receivables and Payables

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

	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Receivables:		
Securities borrowed	\$ 1,377,261	\$ 1,338,855
Securities failed to deliver	38,447	58,244
Other	3,944	7,628
	<u>\$ 1,419,652</u>	<u>\$ 1,404,727</u>
Payables:		
Securities loaned	\$ 1,350,722	\$ 1,245,066
Correspondents	38,648	33,547
Securities failed to receive	82,897	61,589
Trades in process of settlement	21,126	21,765
Other	3,530	6,406
	<u>\$ 1,496,923</u>	<u>\$ 1,368,373</u>

22. Segment and Related Information

Following the sale of NLC on June 30, 2020, we have two primary business units within continuing operations, PCC (banking and mortgage origination) and Securities Holdings (broker-dealer). Under GAAP, our continuing operations business units are comprised of three reportable business segments organized primarily by the core products offered to the segments' respective customers: banking, broker-dealer and mortgage origination. These segments reflect the manner in which operations are managed and the criteria used by the chief operating decision maker, the Company's President and Chief Executive Officer, to evaluate segment performance, develop strategy and allocate resources.

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

As discussed in Note 3 to the consolidated financial statements, during the first quarter of 2020, management had determined that the insurance segment met the criteria to be presented as discontinued operations. On June 30, 2020, Hilltop completed the sale of NLC, which comprised the operations of the former insurance segment. As a result, insurance segment results for the three and nine months ended September 30, 2020 have been presented as discontinued operations in the consolidated financial statements. There was no income from discontinued operations before taxes during the three months ended September 30, 2020, while income from discontinued operations before taxes was \$2.1 million during the nine months ended September 30, 2020.

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.

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

<u>Three Months Ended September 30, 2021</u>	<u>Banking</u>	<u>Broker-Dealer</u>	<u>Mortgage Origination</u>	<u>Corporate</u>	<u>All Other and Eliminations</u>	<u>Continuing Operations</u>
Net interest income (expense)	\$ 99,978	\$ 10,427	\$ (3,503)	\$ (4,341)	\$ 2,529	\$ 105,090
Provision for (reversal of) credit losses	(5,775)	(44)	—	—	—	(5,819)
Noninterest income	11,727	116,143	242,270	757	(2,952)	367,945
Noninterest expense	54,567	109,193	176,587	15,355	(528)	355,174
Income (loss) from continuing operations before taxes . . .	<u>\$ 62,913</u>	<u>\$ 17,421</u>	<u>\$ 62,180</u>	<u>\$ (18,939)</u>	<u>\$ 105</u>	<u>\$ 123,680</u>

Hilltop Holdings Inc. and Subsidiaries
Notes to Consolidated Financial Statements (continued)
(Unaudited)

Nine Months Ended September 30, 2021	Banking	Broker-Dealer	Mortgage Origination	Corporate	All Other and Eliminations	Continuing Operations
Net interest income (expense)	\$ 309,330	\$ 31,623	\$ (16,554)	\$ (13,720)	\$ 8,009	\$ 318,688
Provision for (reversal of) credit losses	(39,725)	77	—	—	—	(39,648)
Noninterest income	33,293	298,229	794,679	8,140	(8,912)	1,125,429
Noninterest expense	167,869	287,831	573,884	37,015	(1,395)	1,065,204
Income (loss) from continuing operations before taxes	<u>\$ 214,479</u>	<u>\$ 41,944</u>	<u>\$ 204,241</u>	<u>\$ (42,595)</u>	<u>\$ 492</u>	<u>\$ 418,561</u>

Three Months Ended September 30, 2020	Banking	Broker-Dealer	Mortgage Origination	Corporate	All Other and Eliminations	Continuing Operations
Net interest income (expense)	\$ 96,416	\$ 8,168	\$ (2,349)	\$ (4,594)	\$ 4,259	\$ 101,900
Provision for (reversal of) credit losses	—	(602)	—	—	—	(602)
Noninterest income	9,819	141,022	355,471	477	(4,078)	502,711
Noninterest expense	55,980	114,393	207,176	21,999	(203)	399,345
Income (loss) from continuing operations before taxes	<u>\$ 50,255</u>	<u>\$ 35,399</u>	<u>\$ 145,946</u>	<u>\$ (26,116)</u>	<u>\$ 384</u>	<u>\$ 205,868</u>

Nine Months Ended September 30, 2020	Banking	Broker-Dealer	Mortgage Origination	Corporate	All Other and Eliminations	Continuing Operations
Net interest income (expense)	\$ 284,440	\$ 31,005	\$ (3,647)	\$ (9,482)	\$ 14,478	\$ 316,794
Provision for (reversal of) credit losses	99,875	98	—	—	—	99,973
Noninterest income	29,246	350,192	874,926	3,315	(15,130)	1,242,549
Noninterest expense	169,569	299,743	547,222	35,741	(820)	1,051,455
Income (loss) from continuing operations before taxes	<u>\$ 44,242</u>	<u>\$ 81,356</u>	<u>\$ 324,057</u>	<u>\$ (41,908)</u>	<u>\$ 168</u>	<u>\$ 407,915</u>

September 30, 2021	Banking	Broker-Dealer	Mortgage Origination	Corporate	All Other and Eliminations	Continuing Operations
Goodwill	\$ 247,368	\$ 7,008	\$ 13,071	\$ —	\$ —	\$ 267,447
Total assets	<u>\$ 14,254,083</u>	<u>\$ 3,426,534</u>	<u>\$ 2,537,342</u>	<u>\$ 2,926,781</u>	<u>\$ (5,155,089)</u>	<u>\$ 17,989,651</u>

December 31, 2020	Banking	Broker-Dealer	Mortgage Origination	Corporate	All Other and Eliminations	Continuing Operations
Goodwill	\$ 247,368	\$ 7,008	\$ 13,071	\$ —	\$ —	\$ 267,447
Total assets	<u>\$ 13,338,930</u>	<u>\$ 3,196,346</u>	<u>\$ 3,285,005</u>	<u>\$ 2,823,374</u>	<u>\$ (5,699,391)</u>	<u>\$ 16,944,264</u>

23. Earnings per Common Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Basic earnings per share:				
Income from continuing operations	\$ 92,906	\$ 152,543	\$ 312,310	\$ 296,729
Income from discontinued operations	—	736	—	34,662
Income attributable to Hilltop	<u>\$ 92,906</u>	<u>\$ 153,279</u>	<u>\$ 312,310</u>	<u>\$ 331,391</u>
Weighted average shares outstanding - basic	80,109	90,200	81,306	90,291
Basic earnings per common share:				
Income from continuing operations	\$ 1.16	\$ 1.69	\$ 3.84	\$ 3.29
Income from discontinued operations	—	0.01	—	0.38
	<u>\$ 1.16</u>	<u>\$ 1.70</u>	<u>\$ 3.84</u>	<u>\$ 3.67</u>
Diluted earnings per share:				
Income from continuing operations	\$ 92,906	\$ 152,543	\$ 312,310	\$ 296,729
Income from discontinued operations	—	736	—	34,662
Income attributable to Hilltop	<u>\$ 92,906</u>	<u>\$ 153,279</u>	<u>\$ 312,310</u>	<u>\$ 331,391</u>
Weighted average shares outstanding - basic	80,109	90,200	81,306	90,291
Effect of potentially dilutive securities	433	—	457	—
Weighted average shares outstanding - diluted	<u>80,542</u>	<u>90,200</u>	<u>81,763</u>	<u>90,291</u>
Diluted earnings per common share:				
Income from continuing operations	\$ 1.15	\$ 1.69	\$ 3.82	\$ 3.29
Income from discontinued operations	—	0.01	—	0.38
	<u>\$ 1.15</u>	<u>\$ 1.70</u>	<u>\$ 3.82</u>	<u>\$ 3.67</u>

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

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

Unless the context otherwise indicates, all references in this 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 “Momentum Independent Network” refer to Momentum Independent Network Inc. (a wholly owned subsidiary of Securities Holdings), Hilltop Securities and Momentum 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 “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 (formerly a wholly owned subsidiary of Hilltop) and its wholly owned subsidiaries.

FORWARD-LOOKING STATEMENTS

This Quarterly Report includes “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 Quarterly Report that address results or developments that we expect or anticipate will or may occur in the future, and statements that are preceded by, followed by or include, words such as “anticipates,” “believes,” “could,” “estimates,” “expects,” “forecasts,” “goal,” “intends,” “may,” “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 revenue, our liquidity and sources of funding, market trends, operations and business, taxes, the impact of natural disasters or public health emergencies, such as the current global outbreak of a novel strain of coronavirus (“COVID-19”), information technology expenses, capital levels, mortgage servicing rights (“MSR”) assets, stock repurchases, dividend payments, expectations concerning mortgage loan origination volume, servicer advances and interest rate compression, expected levels of refinancing as a percentage of total loan origination volume, projected losses on mortgage loans originated, total expenses, the effects of government regulation applicable to our operations, the appropriateness of, and changes in, our allowance for credit losses and provision for (reversal of) credit losses, expected future benchmark rates, 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 COVID-19 pandemic and the response of governmental authorities to the pandemic, which have had, and may continue to have, an adverse impact on the global economy and our business operations and performance;
- the credit risks of lending activities, including our ability to estimate credit losses and the allowance for credit losses, as well as the effects of changes in the level of, and trends in, loan delinquencies and write-offs;
- effectiveness of our data security controls in the face of cyber attacks;
- 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 concentration in real estate related loans;
- changes in the interest rate environment and transitions away from London Interbank Offered Rate (“LIBOR”);
- the effects of our indebtedness on our ability to manage our business successfully, including the restrictions imposed by the indenture governing our indebtedness;
- 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”);
- cost and availability of capital;
- changes in key management;
- competition in our banking, broker-dealer and mortgage origination segments from other banks and financial institutions as well as investment banking and financial advisory firms, mortgage bankers, asset-based non-bank lenders and government agencies;
- legal and regulatory proceedings;
- 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 “Risk Factors” in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2020 (“2020 Form 10-K”), which was filed with the Securities and Exchange Commission (the “SEC”) on February 16, 2021, this Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and other filings we have made with the SEC. We caution that the foregoing list of factors is not exhaustive, and new factors may emerge, or changes to the foregoing factors may occur, that could impact our business. All subsequent written and oral forward-looking statements concerning our business attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements above. We do not undertake any obligation to update any forward-looking statement, whether written or oral, relating to the matters discussed in this Quarterly Report except to the extent required by federal securities laws.

OVERVIEW

We are a financial holding company registered under the Bank Holding Company Act of 1956. 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 and mortgage origination 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, clearing, securities lending, structured finance and retail brokerage services throughout the United States.

During the first quarter of 2020, management determined that the then-pending sale of NLC met the criteria to be presented as discontinued operations. As a result, NLC's results for the three and nine months ended September 30, 2020 have been presented as discontinued operations in the consolidated financial statements. On June 30, 2020, completed the sale of all of the outstanding capital stock of NLC, which comprised the operations of our former insurance segment, for cash proceeds of \$154.1 million. During 2020, Hilltop recognized an aggregate gain associated with this transaction of \$36.8 million, net of \$5.1 million in transaction costs and was subject to post-closing adjustments. The resulting book gain from this sale transaction was not recognized for tax purposes due to the excess tax basis over book basis being greater than the recorded book gain. Any tax loss related to this transaction is deemed disallowed pursuant to the rules under the Internal Revenue Code. We also entered into an agreement at closing to refrain for a specified period from certain activities that compete with the business of NLC. Unless otherwise noted, for purposes of this Management's Discussion and Analysis of Financial Condition and Results of Operations, "consolidated" refers to our consolidated financial position and consolidated results of operations, including discontinued operations and assets and liabilities of the discontinued operations.

During the three and nine months ended September 30, 2021, income applicable to common stockholders was \$92.9 million, or \$1.15 per diluted share, and \$312.3 million, or \$3.82 per diluted share, respectively. We declared total common dividends of \$0.12 and \$0.36 per share during the three and nine months ended September 30, 2021, respectively, resulting in a dividend payout ratio of 10.34% and 9.38%, respectively. Dividend payout ratio is defined as cash dividends declared per common share divided by basic earnings per common share, including discontinued operations. We also paid an aggregate of \$123.6 million to repurchase shares of our common stock during the nine months ended September 30, 2021.

We reported \$123.7 million and \$418.6 million of income from continuing operations before income taxes during the three and nine months ended September 30, 2021, including the following contributions from our reportable business segments.

- The banking segment contributed \$62.9 million and \$214.5 million of income before income taxes during the three and nine months ended September 30, 2021;
- The broker-dealer segment contributed \$17.4 million and \$41.9 million of income before income taxes during the three and nine months ended September 30, 2021; and
- The mortgage origination segment contributed \$62.2 million and \$204.2 million of income before income taxes during the three and nine months ended September 30, 2021.

At September 30, 2021, on a consolidated basis, we had total assets of \$18.0 billion, total deposits of \$12.1 billion, total loans, including loans held for sale, of \$9.6 billion and stockholders' equity of \$2.5 billion.

Recent Developments

COVID-19

The COVID-19 pandemic and related governmental control measures severely disrupted financial markets and overall economic conditions throughout 2020. While the impact of the pandemic and the uncertainties have remained into 2021, significant progress associated with COVID-19 vaccination levels in the United States has resulted in easing of restrictive measures in the United States. Further, the U.S. federal government enacted policies to provide fiscal stimulus to the economy and relief to those affected by the pandemic, with the stimulus intended to bolster household finances as well as those of small businesses, states and municipalities. Throughout the pandemic, we have taken a number of precautionary steps to safeguard our business and our employees from COVID-19, including, but not limited to, banking by appointment, implementing employee travel restrictions and telecommuting arrangements, while maintaining business continuity so that we can continue to deliver service to and meet the demands of our clients. From the start of the pandemic until the second quarter of 2021, most of our employees worked remotely, with only certain operationally critical employees working on site at our principal business headquarters and business segment locations. We began the process of returning a majority of our employees to their respective office locations beginning in the second quarter of 2021 based initially on a rotational team schedule to better ensure that appropriate social distancing measures are followed, and have generally returned to pre-pandemic work arrangements with available hybrid options for designated roles. We are continuing to monitor and assess the impact of the COVID-19 pandemic on a regular basis.

As discussed in more detail within “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of our 2020 Form 10-K, in light of the extreme volatility and disruptions in the capital and credit markets beginning in March 2020 resulting from the COVID-19 crisis and its negative impact on the economy, we took a number of precautionary actions beginning in March 2020 to enhance our financial flexibility, protect capital, minimize losses and ensure target liquidity levels.

As a result of the short-term rate adjustments by the Federal Open Markets Committee (“FOMC”) and the stressed economic outlook during March 2020, mortgage rates fell to historically low levels. Given our exposure to the mortgage market, this precipitous decline in rates resulted in significant growth in mortgage originations at both PrimeLending and Hilltop Securities through its partnerships with certain housing finance authorities. To improve our already strong liquidity position, we raised brokered and other wholesale funding to support the enhanced mortgage activity. To meet increased liquidity demands, we raised brokered deposits during 2020 that have a remaining balance of approximately \$243 million at September 30, 2021, down from approximately \$731 million at December 31, 2020. Further, beginning in March 2020, additional deposits were swept from Hilltop Securities into the Bank. Since June 30, 2020, given the continued strong cash and liquidity levels at the Bank, the total funds swept from Hilltop Securities into the Bank was reduced, and was approximately \$800 million as of September 30, 2021.

Asset Valuation

At each reporting date between annual impairment tests, we consider potential indicators of impairment. Given the current economic uncertainties surrounding COVID-19, we considered whether the events and circumstances resulted in it being more likely than not that the fair value of any reporting unit and other intangible assets were less than their respective carrying value. Impairment indicators considered comprised the condition of the economy and financial services industry; government intervention and regulatory updates; the impact of recent events to financial performance and cost factors of the reporting unit; performance of our stock and other relevant events.

Given the potential impacts as a result of economic uncertainties associated with the pandemic, actual results may differ materially from our current estimates as the scope of such impacts evolves or if the duration of business disruptions is longer than currently anticipated. While certain valuation assumptions and judgments will change to account for pandemic-related circumstances, we do not anticipate significant changes in methodology used to determine the fair value of our goodwill, intangible assets and other long-lived assets. We continue to monitor developments regarding the COVID-19 pandemic and measures implemented in response to the pandemic, market capitalization, overall economic conditions and any other triggering events or circumstances that may indicate an impairment in the future.

To the extent a sustained decline in our stock price or the occurrence of what management would deem to be a triggering event that could, under certain circumstances, cause us to perform impairment tests on our goodwill and other intangible assets, and result in an impairment charge being recorded for that period. In the event that we conclude that all or a

portion of our goodwill and other intangible assets are impaired, a non-cash charge for the respective amount of such impairment would be recorded to earnings. Such a charge would have no impact on tangible capital or regulatory capital.

Loan Portfolio

In response to the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) and the Paycheck Protection Program and Health Care Enhancement Act (the “PPP/HCE Act”) were passed in March 2020, which were intended to provide emergency relief to several groups and individuals impacted by the COVID-19 pandemic. Among the numerous provisions contained in the CARES Act was the creation of a \$349 billion Paycheck Protection Program (“PPP”) that provides federal government loan forgiveness for Small Business Administration (“SBA”) Section 7(a) loans for small businesses, which may include our customers, to pay up to eight weeks of employee compensation and other basic expenses such as electric and telephone bills. Further, the CARES Act allows the Bank to suspend the troubled debt restructuring (“TDR”) requirements for certain loan modifications to be categorized as a TDR.

Starting in March 2020, the Bank implemented several actions to better support our impacted banking clients and allow for loan modifications such as principal and/or interest payment deferrals, participation in the PPP as an SBA preferred lender and personal banking assistance including waived fees, increased daily spending limits and suspension of residential foreclosure activities. The COVID-19 payment deferral programs allow for a deferral of principal and/or interest payments with such deferred principal payments due and payable on the maturity date of the existing loan. The Bank’s actions during 2020 included approval of approximately \$1.0 billion in COVID-19 related loan modifications as of December 31, 2020.

During 2021, the Bank has continued to support its impacted banking clients through the approval of COVID-19 related loan modifications, which resulted in an additional \$15 million of new COVID-19 related loan modifications during the nine months ended September 30, 2021. The portfolio of active deferrals that have not reached the end of their deferral period was approximately \$17 million as of September 30, 2021. While the majority of the portfolio of COVID-19 related loan modifications no longer require deferral, such loans represent elevated risk, and therefore management continues to monitor these loans. The extent to which these measures will impact the Bank remains uncertain, and any progression of loans, whether receiving COVID-19 payment deferrals or not, into non-performing assets, during future periods is uncertain and will depend on future developments that cannot be predicted.

While all industries have experienced varying levels of adverse impacts due to the COVID-19 pandemic, certain of our loan portfolio industry sectors and subsectors continue to have an increased level of risk. The following table provides information on those loans held for investment balances, by portfolio industry sector, including collectively evaluated allowance for credit losses, that include active COVID-19 payment deferrals (dollars in thousands).

September 30, 2021	Active 90 Day Principal Deferrals	Active 90 Day Interest and Principal Deferrals	Total Active Modifications		Classified and Criticized Loans	Allowance for Credit Losses	Allowance for Credit Losses as a % of Total Active Modifications	Allowance for Credit Losses as a % of Classified and Criticized Loans
			(\$)	(#)				
Hotel	\$ 8,966	\$ —	\$ 8,966	1	\$ 8,966	\$ 3,138	35.0 %	35.0 %
Restaurants	—	—	—	—	—	—	— %	— %
Transportation & Warehousing	3,816	—	3,816	6	3,816	692	18.1 %	18.1 %
1-4 Family Residential	—	4,310	4,310	49	3,787	75	1.7 %	2.0 %
Retail	—	—	—	—	—	—	— %	— %
Real Estate & Rental & Leasing	—	—	—	—	—	—	— %	— %
Healthcare and Social Assistance	—	—	—	—	—	—	— %	— %
All Other	—	—	—	—	—	—	— %	— %
	<u>\$ 12,782</u>	<u>\$ 4,310</u>	<u>\$ 17,092</u>	<u>56</u>	<u>\$ 16,569</u>	<u>\$ 3,905</u>	22.8 %	23.6 %

In addition, the Bank’s loan portfolio includes collateralized loans extended to businesses that depend on the energy industry, including those within the exploration and production, field services, pipeline construction and transportation sectors. Crude oil prices have increased since historical lows observed in 2020, but uncertainty remains as economies continue to recover from the COVID-19 pandemic, vaccination programs evolve, and future supply and demand for oil are influenced by a return to business travel, new energy policies and government regulation, and the pace of transition towards renewable energy resources. At September 30, 2021, the Bank’s energy loan exposure was approximately \$72 million of loans held for investment with unfunded commitment balances of approximately \$40 million. The allowance for credit losses on the Bank’s energy portfolio was \$0.3 million, or 0.5% of loans held for investment at September 30, 2021.

As noted above, the Bank’s actions during the second quarter of 2020 and again during the first and second quarters of 2021 included supporting our impacted banking clients through both the initial and second round PPP efforts. These efforts included approval and funding of over 4,100 PPP loans, with approximately \$133 million remaining outstanding at September 30, 2021. The PPP loans made by the Bank are guaranteed by the SBA and, if used by the borrower for authorized purposes, may be fully forgiven. On October 2, 2020, the SBA began approving the Bank’s PPP forgiveness applications and remitting forgiveness payments to PPP lenders for PPP borrowers. Through October 22, 2021, the SBA had approved approximately 3,300 initial and second round PPP forgiveness applications from the Bank totaling approximately \$775 million, with PPP loans of approximately \$12 million pending SBA review and approval.

Refer to the discussion in the “Financial Condition – Allowance for Credit Losses on Loans” section that follows for more details regarding the significant assumptions and estimates involved in estimating credit losses given the economic uncertainties associated with COVID-19.

Outlook

The COVID-19 pandemic has adversely impacted financial markets and overall economic conditions, and is expected to continue to have implications on our business and operations. The extent of the impact of the pandemic on our operational and financial performance for the remainder of 2021 and into 2022 is currently uncertain and will depend on certain developments outside of our control, including, among others, the ongoing distribution and effectiveness of vaccines, government stimulus, the ultimate impact of the pandemic on our customers and clients, and additional, or extended, federal, state and local government orders and regulations that might be imposed in response to the pandemic.

See “Item 1A. Risk Factors” of our 2020 Form 10-K for additional discussion of the potential adverse impact of COVID-19 on our business, results of operations and financial condition.

Factors Affecting Results of Operations

As a financial institution providing products and services through our banking, broker-dealer and mortgage origination 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 results of operations 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 impacting our results of operations include, but are not limited to, fluctuations in volume and price levels of securities, inflation, political events, investor confidence, investor participation levels, legal, regulatory, and compliance requirements and competition. All of these factors have the potential to impact 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.

Factors Affecting Comparability of Results of Operations

NLC Sale

As previously discussed, on June 30, 2020, we completed the sale of all of the outstanding capital stock of NLC, which comprised the operations of our insurance segment. Accordingly, NLC’s results for the three and nine months ended September 30, 2020 have been presented as discontinued operations in the consolidated financial statements.

Tender Offer

On September 23, 2020, we announced the commencement of a modified “Dutch auction” tender offer to purchase shares of our common stock for an aggregate cash purchase price of up to \$350 million. On November 17, 2020, we completed our tender offer, repurchasing 8,058,947 shares of outstanding common stock at a price of \$24.00 per share for a total of \$193.4 million excluding fees and expenses. We funded the tender offer with cash on hand.

Subordinated Notes due 2030 and 2035

On May 7, 2020, we completed a public offering of \$50 million aggregate principal amount of 5.75% fixed-to-floating rate subordinated notes due May 15, 2030 (the “2030 Subordinated Notes”) and \$150 million aggregate principal amount of 6.125% fixed-to-floating rate subordinated notes due May 15, 2035 (the “2035 Subordinated Notes”). We collectively refer to the 2030 Subordinated Notes and the 2035 Subordinated Notes as the “Subordinated Notes”. The price for the Subordinated Notes was 100% of the principal amount of the Subordinated Notes. The net proceeds from the offering, after deducting underwriting discounts and fees and expenses of \$3.4 million, were \$196.6 million. We intend to use the net proceeds of the offerings for general corporate purposes.

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 improve operational efficiencies throughout our organization. During 2018, we began the significant investment in new technological solutions, substantial core system upgrades and other technology enhancements. Such significant investments specifically include single enterprise-wide general ledger and procurement solutions, a mortgage loan origination system and a core system replacement within our broker-dealer segment (collectively referred to as “Core System Improvements”). In combination with these technology enhancements, we are continuing our efforts to consolidate common back office functions. Costs incurred related to these Core System Improvements and the consolidation of common back office functions represented a significant portion of our noninterest expenses throughout 2020. We have made such investments with the expectation that they will result in cost savings over the long term. Beginning in the second quarter of 2019, the mortgage origination segment began the implementation of a new mortgage loan origination system. The transition from the previous mortgage loan origination system was completed during the fourth quarter of 2020. During the second quarter of 2020, we implemented the core system replacement within our broker-dealer segment. This was a highly complex endeavor and the broker-dealer segment continues to work with the technology vendors, clients and internal stakeholders. Additionally, through the third quarter of 2020, we made significant progress in our transition to a single, enterprise-wide general ledger solution by replacing legacy ledgers at our banking and mortgage origination segments, as well as corporate, and, in April 2021, we replaced our only remaining legacy ledger and transitioned our broker-dealer segment to the enterprise-wide general ledger solution.

LIBOR

In July 2017, the Financial Conduct Authority (“FCA”) announced that it intends to cease compelling banks to submit rates for the calculation of LIBOR after 2021. Most recently in March 2021, the FCA and the Intercontinental Exchange (“ICE”) Benchmark Administration concurrently confirmed their original intention to stop requesting banks to submit the rates required to calculate LIBOR after the 2021 calendar year and additionally announced firm target dates for the phase out of various LIBOR tenors. Pursuant to the announcement, one week and two-month LIBOR will cease to be published or lose representativeness immediately after December 31, 2021, and all remaining USD LIBOR tenors will cease to be published or lose representativeness immediately after June 30, 2023.

Working groups comprised of various regulators and other industry groups have been formed in the United States and other countries in order to provide guidance on this topic. In particular, 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. The ARRC has also published recommended fall-back language for LIBOR-linked financial instruments, among numerous other areas of guidance.

The Financial Accounting Standards Board (“FASB”) issued guidance in March 2020 intended to provide temporary optional expedients and exceptions to the accounting principles generally accepted in the United States (“GAAP”) guidance on contract modifications and hedge accounting to ease the financial reporting burdens related to the expected market transition from LIBOR and other interbank offered rates to alternative reference rates. Additionally, the FASB issued specific accounting guidance that permits the use of the Overnight Index Swap rate based on the SOFR to be designated as a benchmark interest rate for hedge accounting purposes.

Certain loans we originated bear interest at a floating rate based on LIBOR. We also pay interest on certain borrowings, are counterparty to derivative agreements, and have existing contracts with payment calculations that use LIBOR as the

reference rate. The cessation of publication of LIBOR will create various risks surrounding the financial, operational, compliance and legal aspects associated with changing certain elements of existing contracts.

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. However, at this time, no consensus exists as to what rate or rates may become acceptable alternatives to LIBOR and it is impossible to predict the effect of any such alternatives on the value of LIBOR-based securities and variable rate loans, debentures, or other securities or financial arrangements, given LIBOR's role in determining market interest rates globally.

We have completed our targeted assessment of exposures across the organization associated with the migration away from LIBOR and have transitioned to the impact assessment and implementation stages. In light of the above described recent changes to the LIBOR phase out dates being pushed out to 2023, we have begun taking necessary actions, including negotiating certain of our agreements based on alternative benchmark rates that have been established. Since the third quarter of 2020, PrimeLending has been originating conventional adjustable-rate mortgage, or ARM, loan products utilizing a SOFR rate with terms consistent with government-sponsored enterprise, or GSE, guidelines. In addition, the Bank's management team continues to work with its commercial relationships that have LIBOR-based contracts maturing after 2021 to amend terms and establish an alternative benchmark rate. We also continue to evaluate the impacts of the LIBOR phase-out and transition requirements as it pertains to contracts, models and systems. To date, an immaterial amount of expenses have been incurred as a result of our efforts; however, in the future we may incur additional expenses as we finalize the transition of our systems and processes away from LIBOR.

Brokered Deposits

In December 2020, the Federal Deposit Insurance Corporation ("FDIC") finalized revisions to its rules and prior guidance regarding brokered deposits (the "Revisions"). The Revisions are intended to modernize the FDIC's framework for regulating brokered deposits and ensure that the classification of a deposit as brokered appropriately reflects changes in the banking landscape. In addition, the Revisions are intended to modify the interest rate restrictions applicable to certain depository institutions and clarify the application of the brokered deposit requirements to non-maturity deposits. The Revisions became effective on April 1, 2021, but full compliance is not required during a transitional period ending January 1, 2022. We have evaluated the Revisions and published FDIC guidance and, after consulting with the FDIC, expect that, effective January 1, 2022, we will continue to treat deposits swept to the banking segment from the broker-dealer segment as non-brokered. At that time, the cost of these sweep deposits will be based on a current market rate of interest rather than a per account fee.

Segment Information

As previously discussed, on June 30, 2020, we completed the sale of all of the outstanding capital stock of NLC, which comprised the operations of the insurance segment. Accordingly, insurance segment results for the three and nine months ended September 30, 2020 have been presented as discontinued operations in the consolidated financial statements and we no longer have an insurance segment. Additional details are presented in Note 3, Discontinued Operations, in the notes to our consolidated financial statements.

Following the above-noted sale of NLC, we have two primary business units within continuing operations, PCC (banking and mortgage origination) and Securities Holdings (broker-dealer). Under GAAP, our business units are comprised of three reportable business segments organized primarily by the core products offered to the segments' respective customers: banking, broker-dealer and mortgage origination. 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 and mortgage origination segments. Operating results for the mortgage origination segment have historically been more volatile than operating results for the banking and broker-dealer segments.

The banking segment includes the operations of the Bank. The banking segment 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. The Bank also derives revenue from other sources, including service charges on customer deposit accounts and trust fees.

The broker-dealer segment includes the operations of Securities Holdings, which operates through its wholly owned subsidiaries Hilltop Securities, Momentum Independent Network and Hilltop Securities Asset Management, LLC. 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 SEC and the Financial Industry Regulatory Authority (“FINRA”) and a member of the New York Stock Exchange (“NYSE”). Momentum Independent Network is an introducing broker-dealer that is also registered with the SEC and FINRA. Hilltop Securities, Momentum Independent Network and Hilltop Securities Asset Management, 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.

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.

The eliminations of intercompany transactions are included in “All Other and Eliminations.” Additional information concerning our reportable segments is presented in Note 22, Segment and Related Information, in the notes to our consolidated financial statements.

The following table presents certain information about the continuing operating results of our reportable segments (in thousands). This table serves as a basis for the discussion and analysis in the segment operating results sections that follow.

	Three Months Ended September 30,		Variance 2021 vs 2020		Nine Months Ended September 30,		Variance 2021 vs 2020	
	2021	2020	Amount	Percent	2021	2020	Amount	Percent
Net interest income (expense):								
Banking	\$ 99,978	\$ 96,416	\$ 3,562	4	\$ 309,330	\$ 284,440	\$ 24,890	9
Broker-Dealer	10,427	8,168	2,259	28	31,623	31,005	618	2
Mortgage Origination	(3,503)	(2,349)	(1,154)	(49)	(16,554)	(3,647)	(12,907)	(354)
Corporate	(4,341)	(4,594)	253	6	(13,720)	(9,482)	(4,238)	(45)
All Other and Eliminations	2,529	4,259	(1,730)	(41)	8,009	14,478	(6,469)	(45)
Hilltop Continuing Operations	\$ 105,090	\$ 101,900	\$ 3,190	3	\$ 318,688	\$ 316,794	\$ 1,894	1
Provision for (reversal of) credit losses:								
Banking	\$ (5,775)	\$ —	\$ (5,775)	NM	\$ (39,725)	\$ 99,875	\$ (139,600)	(140)
Broker-Dealer	(44)	(602)	558	93	77	98	(21)	(21)
Mortgage Origination	—	—	—	—	—	—	—	—
Corporate	—	—	—	—	—	—	—	—
All Other and Eliminations	—	—	—	—	—	—	—	—
Hilltop Continuing Operations	\$ (5,819)	\$ (602)	\$ (5,217)	NM	\$ (39,648)	\$ 99,973	\$ (139,621)	(140)
Noninterest income:								
Banking	\$ 11,727	\$ 9,819	\$ 1,908	19	\$ 33,293	\$ 29,246	\$ 4,047	14
Broker-Dealer	116,143	141,022	(24,879)	(18)	298,229	350,192	(51,963)	(15)
Mortgage Origination	242,270	355,471	(113,201)	(32)	794,679	874,926	(80,247)	(9)
Corporate	757	477	280	59	8,140	3,315	4,825	146
All Other and Eliminations	(2,952)	(4,078)	1,126	28	(8,912)	(15,130)	6,218	41
Hilltop Continuing Operations	\$ 367,945	\$ 502,711	\$ (134,766)	(27)	\$ 1,125,429	\$ 1,242,549	\$ (117,120)	(9)
Noninterest expense:								
Banking	\$ 54,567	\$ 55,980	\$ (1,413)	(3)	\$ 167,869	\$ 169,569	\$ (1,700)	(1)
Broker-Dealer	109,193	114,393	(5,200)	(5)	287,831	299,743	(11,912)	(4)
Mortgage Origination	176,587	207,176	(30,589)	(15)	573,884	547,222	26,662	5
Corporate	15,355	21,999	(6,644)	(30)	37,015	35,741	1,274	4
All Other and Eliminations	(528)	(203)	(325)	(160)	(1,395)	(820)	(575)	(70)
Hilltop Continuing Operations	\$ 355,174	\$ 399,345	\$ (44,171)	(11)	\$ 1,065,204	\$ 1,051,455	\$ 13,749	1
Income (loss) from continuing operations before taxes:								
Banking	\$ 62,913	\$ 50,255	\$ 12,658	25	\$ 214,479	\$ 44,242	\$ 170,237	385
Broker-Dealer	17,421	35,399	(17,978)	(51)	41,944	81,356	(39,412)	(48)
Mortgage Origination	62,180	145,946	(83,766)	(57)	204,241	324,057	(119,816)	(37)
Corporate	(18,939)	(26,116)	7,177	27	(42,595)	(41,908)	(687)	(2)
All Other and Eliminations	105	384	(279)	(73)	492	168	324	193
Hilltop Continuing Operations	\$ 123,680	\$ 205,868	\$ (82,188)	(40)	\$ 418,561	\$ 407,915	\$ 10,646	3

NM Not meaningful.

Key Performance Indicators

We utilize several key indicators of financial condition and operating performance to evaluate the various aspects of our business. In addition to traditional financial metrics, such as revenue and growth trends, we monitor several other financial measures and non-financial operating metrics to help us evaluate growth trends, measure the adequacy of our capital based on regulatory reporting requirements, measure the effectiveness of our operations and assess operational efficiencies. These indicators change from time to time as the opportunities and challenges in our businesses change.

Specifically, performance ratios and asset quality ratios are typically used for measuring the performance of banking and financial institutions. We consider return on average stockholders' equity, return on average assets and net interest margin to be important supplemental measures of operating performance that are commonly used by securities analysts, investors and other parties interested in the banking and financial industry. The net charge-offs to average loans outstanding ratio is also considered a key measure for our banking segment as it indicates the performance of our loan portfolio.

In addition, we consider regulatory capital ratios to be key measures that are used by us, as well as banking regulators, investors and analysts, to assess our regulatory capital position and to compare our regulatory capital to that of other financial services companies. We monitor our capital strength in terms of both leverage ratio and risk-based capital ratios based on capital requirements administered by the federal banking agencies. The risk-based capital ratios are minimum supervisory ratios generally applicable to banking organizations, but banking organizations are widely expected to operate with capital positions well above the minimum ratios. Failure to meet minimum capital requirements can initiate certain mandatory actions by regulators that, if undertaken, could have a material effect on our financial condition or results of operations.

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 and is primarily earned by our banking segment. 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. Net interest income from continuing operations increased during the nine months ended September 30, 2021, compared with the same period in 2020, primarily due to an increase within our banking segment, significantly offset by decreases within our mortgage origination segment and within corporate.

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. We generated \$220.6 million and \$196.0 million in securities commissions and fees and investment and securities advisory fees and commissions, and \$70.1 million and \$143.0 million in gains from derivative and trading portfolio activities (included within other noninterest income), during the nine months ended September 30, 2021 and 2020, respectively.
- (ii) *Income from mortgage operations.* Through PrimeLending, we generate noninterest income by originating and selling mortgage loans. During the nine months ended September 30, 2021 and 2020, we generated \$793.9 million and \$875.3 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.

In the aggregate, we experienced a decrease in noninterest income from continuing operations during the nine months ended September 30, 2021, compared to the same period in 2020, as noted in the segment results table previously presented, primarily due to a decrease of \$81.3 million in net gains from sale of loans, other mortgage production income and mortgage loan origination fees within our mortgage origination segment and a decrease in our broker-dealer segment.

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

Income from continuing operations applicable to common stockholders during the three months ended September 30, 2021 was \$92.9 million, or \$1.15 per diluted share, compared with \$152.5 million, or \$1.69 per diluted share, during the three months ended September 30, 2020. Income from continuing operations applicable to common stockholders during the nine months ended September 30, 2021 was \$312.3 million, or \$3.82 per diluted share, compared with \$296.7 million, or \$3.29 per diluted share, during the nine months ended September 30, 2020. Hilltop's financial results from continuing operations for the three and nine months ended September 30, 2021, compared with the same periods in 2020, reflect a significant decrease in year-over-year mortgage origination segment net gains from sales of loans and other mortgage production income as well as declines in net revenues within the broker-dealer segment's structured finance business and fixed income services lines, while the comparable nine month periods within the banking segment also reflected positive changes in macroeconomic and loan expected loss rates during 2021 as opposed to a significant build in the allowance for credit losses given the market disruption and economic uncertainties caused by COVID-19 during 2020.

Including income from discontinued operations, net of income taxes, income applicable to common stockholders was \$153.3 million, or \$1.70 per diluted share, and \$331.4 million, or \$3.67 per diluted share, during the three and nine months ended September 30, 2020, respectively.

Certain items included in net income for the three and nine months ended September 30, 2021 and 2020 resulted from purchase accounting associated with the merger of PlainsCapital Corporation with and into a wholly owned subsidiary of Hilltop on November 30, 2012, the FDIC-assisted transaction whereby the Bank acquired certain assets and assumed certain liabilities of FNB, the acquisition of SWS Group, Inc. in a stock and cash transaction, and the acquisition of The Bank of River Oaks in an all-cash transaction (collectively, the "Bank Transactions"). Income before income taxes during the three months ended September 30, 2021 and 2020 included net accretion on earning assets and liabilities of \$3.3 million and \$3.6 million, respectively, and amortization of identifiable intangibles of \$1.3 million and \$1.6 million, respectively, related to the Bank Transactions. During the nine months ended September 30, 2021 and 2020, income before income taxes included net accretion on earning assets and liabilities of \$14.4 million and \$13.5 million, respectively, and amortization of identifiable intangibles of \$4.0 million and \$4.9 million, respectively, related to the Bank Transactions.

The information shown in the table below includes certain key performance indicators on a consolidated basis.

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Return on average stockholders' equity ⁽¹⁾	14.96 %	25.94 %	17.26 %	19.85 %
Return on average assets ⁽²⁾	2.13 %	3.71 %	2.43 %	2.90 %
Net interest margin ⁽³⁾⁽⁴⁾	2.53 %	2.56 %	2.61 %	2.90 %
Leverage ratio ⁽⁵⁾ (end of period)			12.64 %	13.03 %
Common equity Tier 1 risk-based capital ratio ⁽⁶⁾ (end of period)			21.28 %	19.85 %

- (1) Return on average stockholders' equity is defined as consolidated income attributable to Hilltop divided by average total Hilltop stockholders' equity.
- (2) Return on average assets is defined as consolidated net income divided by average assets.
- (3) Net interest margin is defined as net interest income divided by average interest-earning assets. We consider net interest margin as a key indicator of profitability, as it represents interest earned on our interest-earning assets compared to interest incurred.
- (4) The securities financing operations within our broker-dealer segment had the effect of lowering both the net interest margin and taxable equivalent net interest margin by 18 basis points and 18 basis points during the three months ended September 30, 2021 and 2020, respectively, and 18 basis points and 25 basis points during the nine months ended September 30, 2021 and 2020, respectively.
- (5) The leverage ratio is a regulatory capital ratio and is defined as Tier 1 risk-based capital divided by average consolidated assets.
- (6) The common equity Tier 1 risk-based capital ratio is a regulatory capital ratio and is defined as common equity Tier 1 risk-based capital divided by risk weighted assets. Common equity includes common equity Tier 1 capital (common stockholders' equity and certain minority interests in the equity capital accounts of consolidated subsidiaries, but excluding goodwill and various intangible assets) and additional Tier 1 capital (certain qualifying minority interests not included in common equity Tier 1 capital, certain preferred stock and related surplus, and certain subordinated debt).

We present net interest margin and net interest income below, on a taxable-equivalent basis. 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 rate of 21% for all 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.

During the three months ended September 30, 2021 and 2020, purchase accounting contributed 9 and 10 basis points, respectively, to our consolidated taxable equivalent net interest margin of 2.54% and 2.57%, respectively. During the nine months ended September 30, 2021 and 2020, purchase accounting contributed 13 and 14 basis points, respectively, to our consolidated taxable equivalent net interest margin of 2.62% and 2.90%, respectively. The purchase accounting activity was primarily related to the accretion of discount of loans which totaled \$3.2 million and \$3.6 million during the three months ended September 30, 2021 and 2020, respectively, associated with the Bank Transactions. The purchase accounting activity was primarily related to the accretion of discount of loans which totaled \$14.1 million and \$13.5 million during the nine months ended September 30, 2021 and 2020, respectively, associated with the Bank Transactions.

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

	Three Months Ended September 30,					
	2021			2020		
	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate
Assets						
Interest-earning assets						
Loans held for sale	\$ 2,300,939	\$ 17,696	3.08 %	\$ 2,530,805	\$ 20,108	3.18 %
Loans held for investment, gross ⁽¹⁾	7,514,392	82,073	4.33 %	7,730,711	84,847	4.32 %
Investment securities - taxable	2,585,362	12,328	1.91 %	1,974,911	11,017	2.23 %
Investment securities - non-taxable ⁽²⁾	318,408	3,252	4.09 %	243,716	2,011	3.30 %
Federal funds sold and securities purchased under agreements to resell	161,577	207	— %	154,588	10	0.03 %
Interest-bearing deposits in other financial institutions	2,197,478	788	0.14 %	1,794,652	626	0.14 %
Securities borrowed	1,364,726	8,585	2.46 %	1,297,112	10,705	3.23 %
Other	51,350	813	6.28 %	49,701	823	6.59 %
Interest-earning assets, gross ⁽²⁾	16,494,232	125,742	3.02 %	15,776,196	130,147	3.26 %
Allowance for credit losses	(115,688)			(156,071)		
Interest-earning assets, net	16,378,544			15,620,125		
Noninterest-earning assets	1,371,207			1,493,194		
Total assets	\$ 17,749,751			\$ 17,113,319		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 7,622,748	\$ 5,303	0.28 %	\$ 7,868,100	\$ 10,700	0.54 %
Securities loaned	1,306,314	6,519	1.98 %	1,193,497	8,729	2.91 %
Notes payable and other borrowings	1,231,545	8,266	2.66 %	1,259,559	8,500	2.69 %
Total interest-bearing liabilities	10,160,607	20,088	0.78 %	10,321,156	27,929	1.08 %
Noninterest-bearing liabilities						
Noninterest-bearing deposits	4,299,987			3,508,282		
Other liabilities	800,225			903,571		
Total liabilities	15,260,819			14,733,009		
Stockholders' equity	2,463,821			2,350,900		
Noncontrolling interest	25,111			29,410		
Total liabilities and stockholders' equity	\$ 17,749,751			\$ 17,113,319		
Net interest income ⁽²⁾		\$ 105,654			\$ 102,218	
Net interest spread ⁽²⁾			2.24 %			2.18 %
Net interest margin ⁽²⁾			2.54 %			2.57 %

	Nine Months Ended September 30,					
	2021			2020		
	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate
Assets						
Interest-earning assets						
Loans held for sale	\$ 2,440,668	\$ 51,059	2.79 %	\$ 2,153,565	\$ 55,775	3.45 %
Loans held for investment, gross ⁽¹⁾	7,628,599	257,149	4.50 %	7,580,436	268,208	4.67 %
Investment securities - taxable	2,432,268	33,666	1.85 %	1,818,953	40,112	2.94 %
Investment securities - non-taxable ⁽²⁾	307,718	8,261	3.58 %	222,818	5,729	3.43 %
Federal funds sold and securities purchased under agreements to resell	138,191	208	— %	92,722	138	0.20 %
Interest-bearing deposits in other financial institutions	1,876,943	1,998	0.14 %	1,277,130	2,679	0.28 %
Securities borrowed	1,435,862	53,143	4.88 %	1,413,473	36,915	3.43 %
Other	50,281	2,568	6.83 %	62,690	2,774	5.91 %
Interest-earning assets, gross ⁽²⁾	16,310,530	408,052	3.34 %	14,621,787	412,330	3.73 %
Allowance for credit losses	(136,400)			(111,070)		
Interest-earning assets, net	16,174,130			14,510,717		
Noninterest-earning assets	1,468,459			1,576,485		
Total assets	\$ 17,642,589			\$ 16,087,202		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 7,662,951	\$ 19,220	0.34 %	\$ 7,354,534	\$ 37,771	0.69 %
Securities loaned	1,358,104	44,350	4.37 %	1,316,032	30,802	3.13 %
Notes payable and other borrowings	1,210,578	24,660	2.72 %	1,246,087	25,043	2.67 %
Total interest-bearing liabilities	10,231,633	88,230	1.15 %	9,916,653	93,616	1.26 %
Noninterest-bearing liabilities						
Noninterest-bearing deposits	4,040,649			3,182,002		
Other liabilities	925,689			732,530		
Total liabilities	15,197,971			13,831,185		
Stockholders' equity	2,418,804			2,229,882		
Noncontrolling interest	25,814			26,135		
Total liabilities and stockholders' equity	\$ 17,642,589			\$ 16,087,202		
Net interest income ⁽²⁾		\$ 319,822			\$ 318,714	
Net interest spread ⁽²⁾			2.19 %			2.47 %
Net interest margin ⁽²⁾			2.62 %			2.90 %

(1) Average balance includes non-accrual loans.

(2) Presented on a taxable equivalent basis with annualized taxable equivalent adjustments based on the applicable corporate federal income tax rate of 21% for the periods presented. The adjustment to interest income was \$0.6 million and \$0.3 million for the three months ended September 30, 2021 and 2020, respectively, and \$1.2 million and \$0.9 million for the nine months ended September 30, 2021 and 2020, 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 (operating segments) by the banking segment, are eliminated from the consolidated financial statements. Our consolidated net interest margins for the three and nine months ended September 30, 2021 and 2020 were also negatively impacted by certain actions taken by management during 2020 to strengthen our available liquidity position. Such actions, including increasing overall cash balances by raising brokered money market and brokered time deposits and raising capital through the issuance of subordinated debt, were taken out of an abundance of caution in light of the extreme volatility and disruptions in the capital and credit markets beginning in March 2020 resulting from the COVID-19 crisis and its negative impact on the economy.

On a consolidated basis, the increases in net interest income during the three and nine months ended September 30, 2021, compared with the same periods in 2020, were primarily due to the effects of decreased net yields on mortgage loans held for sale, interest incurred beginning in May 2020 related to the Subordinated Notes at corporate, and the decrease in market interest rates on deposits within the banking segment. Refer to the discussion in the "Banking Segment" section that follows for more details on the changes in net interest income, 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.

The provision for (reversal of) credit losses is determined by management as the amount necessary to maintain the allowance for credit losses at the amount of expected credit losses inherent within the loans held for investment portfolio. The amount of expense and the corresponding level of allowance for credit losses for loans are based on our evaluation of the collectability of the loan portfolio based on historical loss experience, reasonable and supportable forecasts, and

other significant qualitative and quantitative factors. Substantially all of our consolidated provision for (reversal of) credit losses is related to the banking segment. During the three and nine months ended September 30, 2021, the reversal of credit losses was primarily impacted by the banking segment's reduction in reserves associated with collectively evaluated loans within the portfolio attributable to improvements in both macroeconomic forecast assumptions and credit quality metrics on COVID-19 impacted industry sector exposures. Refer to the discussion in the "Financial Condition – Allowance for Credit Losses on Loans" section that follows for more details regarding the significant assumptions and estimates involved in estimating credit losses.

Noninterest income from continuing operations decreased during the three months ended September 30, 2021, compared with the same period in 2020, primarily due to decrease in average loan sales margin, and to a lesser extent a decrease in total mortgage loan sales volume, and changes in net fair value and related derivative activity within our mortgage origination segment, as well as decreases in structured finance and fixed income services net revenues within our broker-dealer segment. Noninterest income from continuing operations decreased during the nine months ended September 30, 2021, compared with the same period in 2020, primarily due to changes in net fair value and related derivative activity, partially offset by an increase in total mortgage loan sales volume within our mortgage origination segment, as well as decreases in structured finance and fixed income services net revenues within our broker-dealer segment.

Noninterest expense from continuing operations decreased during the three months ended September 30, 2021, compared with the same period in 2020, primarily due to decreases in variable compensation within our mortgage origination and broker-dealer segments. Noninterest expense from continuing operations increased during the nine months ended September 30, 2021, compared with the same period in 2020, primarily due to increases in both variable and non-variable compensation within our mortgage origination segment associated with the increased mortgage loan originations, partially offset by a decline in variable compensation within our broker-dealer segment.

Effective income tax rates from continuing operations during the three months ended September 30, 2021 and 2020 were 22.8% and 22.7%, respectively, and for the nine months ended September 30, 2021 and 2020, were 23.2% and 23.0%, respectively, and approximated the applicable statutory rates for such periods.

Segment Results from Continuing Operations

Banking Segment

The following table presents certain information about the operating results of our banking segment (in thousands).

	Three Months Ended September 30,		Variance	Nine Months Ended September 30,		Variance
	2021	2020	2021 vs 2020	2021	2020	2021 vs 2020
Net interest income	\$ 99,978	\$ 96,416	\$ 3,562	\$ 309,330	\$ 284,440	\$ 24,890
Provision for (reversal of) credit losses	(5,775)	—	(5,775)	(39,725)	99,875	(139,600)
Noninterest income	11,727	9,819	1,908	33,293	29,246	4,047
Noninterest expense	54,567	55,980	(1,413)	167,869	169,569	(1,700)
Income (loss) before income taxes	\$ 62,913	\$ 50,255	\$ 12,658	\$ 214,479	\$ 44,242	\$ 170,237

The increases in income before income taxes during the three and nine months ended September 30, 2021, compared with the same periods in 2020, were primarily due to the combined impact of reversals of credit losses during each quarter of 2021, which reflected improvement in both realized economic results and the macroeconomic outlook, as opposed to significant increases in the provision for credit losses during the first and second quarters of 2020 associated with the adoption of the "current expected credit losses" (CECL) model and the significant market disruption caused by COVID-19. Changes to net interest income related to 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 are discussed in more detail below.

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

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Efficiency ratio ⁽¹⁾	48.85 %	52.69 %	49.00 %	54.06 %
Return on average assets ⁽²⁾	1.36 %	1.14 %	1.58 %	0.36 %
Net interest margin ⁽³⁾	2.99 %	3.03 %	3.16 %	3.28 %
Net recoveries (charge-offs) to average loans outstanding ⁽⁴⁾	0.00 %	(0.03)%	0.00 %	(0.35)%

- (1) Efficiency ratio is defined as noninterest expenses divided by the sum of total noninterest income and net interest income for the period. We consider the efficiency ratio to be a measure of the banking segment's profitability.
- (2) Return on average assets is defined as net income divided by average assets.
- (3) Net interest margin is defined as net interest income divided by average interest-earning assets. We consider net interest margin as a key indicator of profitability, as it represents interest earned on interest-earning assets compared to interest incurred.
- (4) Net recoveries (charge-offs) to average loans outstanding is defined as the greater of recoveries or charge-offs during the reported period minus charge-offs or recoveries divided by average loans outstanding. We use the ratio to measure the credit performance of our loan portfolio.

The banking segment presents net interest margin and net interest income in the following discussion and tables below on a taxable equivalent basis. 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 rate of 21% for all 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.

During the three months ended September 30, 2021 and 2020, purchase accounting contributed 11 and 13 basis points, respectively, to the banking segment's taxable equivalent net interest margin of 3.00% and 3.03%, respectively. During the nine months ended September 30, 2021, purchase accounting contributed 16 and 17 basis points, respectively, to the banking segment's taxable equivalent net interest margin of 3.17% and 3.29%, respectively. These purchase accounting items are primarily related to accretion of discount of loans associated with the Bank Transactions presented in the Consolidated Operating Results section.

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

	Three Months Ended September 30,					
	2021			2020		
	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate
Assets						
Interest-earning assets						
Loans held for investment, gross ⁽¹⁾	\$ 6,906,305	\$ 77,825	4.47 %	\$ 7,287,758	\$ 81,216	4.39 %
Subsidiary warehouse lines of credit	2,113,964	20,239	3.75 %	2,188,068	20,977	3.75 %
Investment securities - taxable	2,110,509	7,772	1.47 %	1,451,049	7,170	1.98 %
Investment securities - non-taxable ⁽²⁾	113,474	966	3.41 %	112,113	960	3.43 %
Federal funds sold and securities purchased under agreements to resell	744	—	— %	400	—	0.06 %
Interest-bearing deposits in other financial institutions	1,971,325	788	0.16 %	1,561,910	396	0.10 %
Other	36,754	130	1.40 %	36,676	42	0.46 %
Interest-earning assets, gross ⁽²⁾	13,253,075	107,720	3.22 %	12,637,974	110,761	3.45 %
Allowance for credit losses	(115,001)			(155,531)		
Interest-earning assets, net	13,138,074			12,482,443		
Noninterest-earning assets	962,472			1,049,072		
Total assets	\$ 14,100,546			\$ 13,531,515		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 7,467,386	\$ 7,144	0.38 %	\$ 7,878,593	\$ 13,723	0.69 %
Notes payable and other borrowings	140,016	391	1.11 %	166,687	425	1.01 %
Total interest-bearing liabilities	7,607,402	7,535	0.39 %	8,045,280	14,148	0.70 %
Noninterest-bearing liabilities						
Noninterest-bearing deposits	4,632,213			3,682,422		
Other liabilities	156,358			144,439		
Total liabilities	12,395,973			11,872,141		
Stockholders' equity	1,704,573			1,659,374		
Total liabilities and stockholders' equity	\$ 14,100,546			\$ 13,531,515		
Net interest income ⁽²⁾		\$ 100,185			\$ 96,613	
Net interest spread ⁽²⁾			2.83 %			2.75 %
Net interest margin ⁽²⁾			3.00 %			3.03 %
Nine Months Ended September 30,						
	2021			2020		
	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate	Average Outstanding Balance	Interest Earned or Paid	Annualized Yield or Rate
Assets						
Interest-earning assets						
Loans held for investment, gross ⁽¹⁾	\$ 7,083,355	\$ 245,332	4.63 %	\$ 7,107,779	\$ 254,553	4.72 %
Subsidiary warehouse lines of credit	2,265,504	64,441	3.75 %	1,922,809	55,309	3.78 %
Investment securities - taxable	1,952,961	21,289	1.45 %	1,303,455	21,249	2.17 %
Investment securities - non-taxable ⁽²⁾	114,965	2,951	3.42 %	111,158	2,837	3.40 %
Federal funds sold and securities purchased under agreements to resell	514	—	— %	454	1	0.18 %
Interest-bearing deposits in other financial institutions	1,626,918	1,515	0.12 %	1,066,096	1,642	0.21 %
Other	36,825	358	1.30 %	45,065	293	0.87 %
Interest-earning assets, gross ⁽²⁾	13,081,042	335,886	3.43 %	11,556,816	335,884	3.84 %
Allowance for credit losses	(135,979)			(110,729)		
Interest-earning assets, net	12,945,063			11,446,087		
Noninterest-earning assets	975,701			987,269		
Total assets	\$ 13,920,764			\$ 12,433,356		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities						
Interest-bearing deposits	\$ 7,523,106	\$ 24,738	0.44 %	\$ 7,237,043	\$ 48,624	0.90 %
Notes payable and other borrowings	139,698	1,191	1.14 %	221,177	2,249	1.34 %
Total interest-bearing liabilities	7,662,804	25,929	0.45 %	7,458,220	50,873	0.91 %
Noninterest-bearing liabilities						
Noninterest-bearing deposits	4,411,823			3,252,584		
Other liabilities	160,643			122,908		
Total liabilities	12,235,270			10,833,712		
Stockholders' equity	1,685,494			1,599,644		
Total liabilities and stockholders' equity	\$ 13,920,764			\$ 12,433,356		
Net interest income ⁽²⁾		\$ 309,957			\$ 285,011	
Net interest spread ⁽²⁾			2.98 %			2.93 %
Net interest margin ⁽²⁾			3.17 %			3.29 %

(1) Average balance includes non-accrual loans.

- (2) Presented on a taxable equivalent basis with annualized taxable equivalent adjustments based on the applicable corporate federal income tax rates of 21% for all the periods presented. The adjustment to interest income was \$0.2 million and \$0.2 million for both the three months ended September 30, 2021 and 2020, respectively, and \$0.6 million and \$0.6 million for both the nine months ended September 30, 2021 and 2020, 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. The banking segment's net interest margin for the three and nine months ended September 30, 2021 and 2020 were negatively impacted by certain actions taken by management during 2020 to strengthen the Bank's available liquidity position. Such actions, including increasing overall cash balances by raising brokered money market and brokered time deposits, were taken out of an abundance of caution in light of the extreme volatility and disruptions in the capital and credit markets beginning in March 2020 resulting from the COVID-19 crisis and its negative impact on the economy.

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).

	<u>Three Months Ended September 30,</u>			<u>Nine Months Ended September 30,</u>		
	<u>2021 vs. 2020</u>			<u>2021 vs. 2020</u>		
	<u>Change Due To ⁽¹⁾</u>			<u>Change Due To ⁽¹⁾</u>		
	<u>Volume</u>	<u>Yield/Rate</u>	<u>Change</u>	<u>Volume</u>	<u>Yield/Rate</u>	<u>Change</u>
Interest income						
Loans held for investment, gross.	\$ (4,221)	\$ 830	\$ (3,391)	\$ (862)	\$ (8,359)	\$ (9,221)
Subsidiary warehouse lines of credit	(700)	(38)	(738)	9,689	(557)	9,132
Investment securities - taxable	3,291	(2,689)	602	10,542	(10,502)	40
Investment securities - non-taxable ⁽²⁾	12	(6)	6	97	17	114
Federal funds sold and securities purchased under agreements to resell	—	—	—	—	(1)	(1)
Interest-bearing deposits in other financial institutions	103	289	392	881	(1,008)	(127)
Other	—	88	88	(54)	119	65
Total interest income ⁽²⁾	<u>(1,515)</u>	<u>(1,526)</u>	<u>(3,041)</u>	<u>20,293</u>	<u>(20,291)</u>	<u>2</u>
Interest expense						
Deposits.	\$ (715)	\$ (5,864)	\$ (6,579)	\$ 1,926	\$ (25,812)	\$ (23,886)
Notes payable and other borrowings.	(68)	34	(34)	(817)	(241)	(1,058)
Total interest expense	<u>(783)</u>	<u>(5,830)</u>	<u>(6,613)</u>	<u>1,109</u>	<u>(26,053)</u>	<u>(24,944)</u>
Net interest income ⁽²⁾	<u>\$ (732)</u>	<u>\$ 4,304</u>	<u>\$ 3,572</u>	<u>\$ 19,184</u>	<u>\$ 5,762</u>	<u>\$ 24,946</u>

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

(2) Annualized taxable equivalent.

Changes in the yields earned on interest-earning assets decreased taxable net interest income during the three and nine months ended September 30, 2021, compared to the same periods in 2020, primarily as a result of lower reinvestment yields on the securities portfolio, and during the nine months ended September 30, 2021, a reduction in yields on loans held for investment. In addition, PPP loan-related fee income increased by \$3.4 million and \$15.5 million and accretion of discount on loans decreased by \$0.1 million and increased \$0.6 million, respectively. Accretion of discount on loans is expected to decrease in future periods as loans acquired in the Bank Transactions are repaid, refinanced or renewed. Changes in the volume of interest-earning assets during the three and nine months ended September 30, 2021, compared to the same periods in 2020, were primarily due to the changes in loans held for investment, mortgage warehouse lending and investment securities portfolio balances. Changes in rates paid on interest-bearing liabilities increased taxable equivalent net interest income during the three and nine months ended September 30, 2021, compared with the same periods in 2020, due to decreases in market interest rates. Our portfolio includes loans that periodically reprice or mature prior to the end of an amortized term. Some of our variable-rate loans remain at applicable rate floors, which may delay and/or limit changes in net interest income during a period of changing rates. If interest rates were to fall further,

the impact on our net interest income for certain variable-rate loans would be limited by these rate floors. In addition, declining interest rates may reduce our cost of funds on deposits. The extent of this impact will ultimately be driven by the timing, magnitude and frequency of interest rate and yield curve movements, as well as changes in market conditions and timing of management strategies. If interest rates were to rise, yields on the portion of our loan portfolio that remain at applicable rate floors would rise more slowly than increases in market interest rates. 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.

In response to the COVID-19 pandemic, the Bank implemented several actions to better support our impacted banking clients. Such programs include loan modifications such as principal and/or interest payment deferrals, participation in the PPP as an SBA preferred lender and personal banking assistance including waived fees, increased daily spending limits and suspension of residential foreclosure activities. The adverse economic conditions caused by the COVID-19 pandemic negatively impacted the banking segment's business and results of operations, including significantly reduced demand for loan products and services from customers, recognition of credit losses and increases in allowance for credit losses. In the event future operating performance is below our projections, there are negative changes to the projected provision for credit losses on loans, or long-term loan and deposit growth rates or discount rates increase, the estimated fair value of the banking reporting unit may decline below carrying value, and we may be required to record a goodwill impairment charge. Additionally, with respect to its core deposit intangible assets, in the event that the deposit retention levels and derived cost savings from available core deposits at the Bank relative to an alternative cost of funds falls to a level that cannot support the remaining carrying value, we may be required to record an impairment charge. We will continue to monitor developments regarding the COVID-19 pandemic and measures implemented in response to the pandemic, market capitalization, overall economic conditions, effectiveness of vaccinations, government stimulus, payment deferral programs and any other triggering events or circumstances that may indicate an impairment in the future. See further detail in the "Recent Developments" section above.

The banking segment retained approximately \$227.7 million and \$12.8 million during the three months ended September 30, 2021 and 2020, respectively, and \$567.5 million and \$155.3 million during the nine months ended September 30, 2021 and 2020, respectively, in mortgage loans originated by the mortgage origination segment. These loans are purchased by the banking segment at par. For origination services provided, the banking segment reimburses the mortgage origination segment for direct origination costs associated with these mortgage loans, in addition to payment of a correspondent fee. The correspondent fees are eliminated in consolidation. In March 2020, the Bank made a decision to sell the previously purchased mortgage loans to the mortgage origination segment, instead of holding them for investment. In October 2020, the Bank resumed purchasing and retaining mortgage loans originated by the mortgage origination segment. We expect loans originated by the mortgage origination segment on behalf of and retained by the banking segment to increase based on approved authority for up to 5% of the mortgage origination segment's total origination volume during 2021. The determination of mortgage loan retention levels by the banking segment will be impacted by, among other things, an ongoing review of the prevailing mortgage rates, balance sheet positioning at Hilltop and the banking segment's outlook for commercial loan growth.

The banking segment's provision for (reversal of) credit losses has been subject to significant year-over-year and quarterly changes primarily attributable to the effects of the deteriorating economic outlook associated with the impact of the market disruption caused by the COVID-19 pandemic beginning in March 2020, and then the reduction in reserves associated with improvements in macroeconomic forecast assumptions. Specifically, the banking segment's provision for credit losses during the three months ended September 30, 2020 included a net reversal of credit losses on individually evaluated loans of \$1.2 million, while the provision for credit losses on expected losses of collectively evaluated loans accounted for \$0.6 million of the total provision primarily due to the identified changes in the Bank's loan portfolio composition and credit quality being offset by improvements in macroeconomic factor assumptions and qualitative factors from the prior quarter. The change in the allowance during the three months ended September 30, 2020 was also impacted by net charge-offs of \$0.6 million. During the nine months ended September 30, 2020, the significant build in the allowance included provision for credit losses on individually evaluated loans of \$22.6 million, while the provision for credit losses on expected losses of collectively evaluated loans accounted for \$77.2 million of the total provision primarily due to the increase in the expected lifetime credit losses under CECL attributable to the deteriorating economic outlook associated with the impact of the market disruption caused by the COVID-19 pandemic. The changes in provision for credit losses during the noted periods were also attributable to other factors including, but not limited to, loan growth, loan mix and changes in risk rating grades. The change in the allowance during the nine months ended September 30, 2020 was also impacted by net charge-offs of \$18.5 million, primarily associated with loans specifically reserved for during the first quarter of 2020.

During the three and nine months ended September 30, 2021, the banking segment had net reversals of credit losses on expected losses of collectively evaluated loans of \$11.0 million and \$45.2 million, respectively, primarily due to improvements in both macroeconomic forecast assumptions and credit quality metrics on COVID-19 impacted industry sector exposures. The net impact to the allowance of changes associated with individually evaluated loans during the three and nine months ended September 30, 2021 included a provision for credit losses of \$5.2 million and \$5.5 million, respectively. The changes in the allowance for credit losses during the noted periods also reflected other factors including, but not limited to, loan mix, and changes in loan balances and qualitative factors from the prior quarter. The changes in the allowance during both the three and nine months ended September 30, 2021 were also impacted by net recoveries of \$0.1 million. Refer to the discussion in the “Financial Condition – Allowance for Credit Losses on Loans” section that follows for more details regarding the significant assumptions and estimates involved in estimating credit losses.

The banking segment’s noninterest income increased during the three and nine months ended September 30, 2021, compared to the same periods in 2020, primarily due to increased other real estate owned (“OREO”) income as well as service charges on depositor accounts.

The banking segment’s noninterest expense decreased during the three and nine months ended September 30, 2021, compared to the same periods in 2020, primarily due to decreases in the reserve for unfunded commitments attributable to year-over-year improvements in loan expected loss rates as well as reductions in legal expenses, partially offset by increases in FDIC assessment and OREO expenses.

Broker-Dealer Segment

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2021	2020	Variance 2021 vs 2020	2021	2020	Variance 2021 vs 2020
Net interest income:						
Wealth management:						
Securities lending	\$ 2,066	\$ 1,976	\$ 90	\$ 8,793	\$ 6,113	\$ 2,680
Clearing services	1,922	1,150	772	5,155	5,720	(565)
Structured finance ⁽⁵⁾	469	448	21	1,342	5,021	(3,679)
Fixed income services	5,354	3,223	2,131	13,667	8,906	4,761
Other ⁽⁵⁾	616	1,371	(755)	2,666	5,245	(2,579)
Total net interest income	10,427	8,168	2,259	31,623	31,005	618
Noninterest income:						
Securities commissions and fees by business line ⁽¹⁾ :						
Fixed income services	9,807	10,961	(1,154)	38,720	36,734	1,986
Wealth management:						
Retail ⁽⁵⁾	18,954	16,003	2,951	55,743	52,401	3,342
Clearing services	5,215	6,478	(1,263)	17,037	23,443	(6,406)
Structured finance ⁽⁵⁾	1,206	335	871	1,877	1,499	378
Other ⁽⁵⁾	964	1,578	(614)	2,851	3,632	(781)
	36,146	35,355	791	116,228	117,709	(1,481)
Investment and securities advisory fees and commissions by business line:						
Public finance services ⁽⁵⁾	37,087	25,577	11,510	77,737	63,138	14,599
Fixed income services ⁽⁵⁾	3,234	3,919	(685)	5,350	5,327	23
Wealth management:						
Retail	8,299	6,193	2,106	23,330	17,237	6,093
Clearing services	472	431	41	1,480	1,140	340
Structured finance ⁽⁵⁾	429	652	(223)	1,431	2,061	(630)
Other	125	94	31	281	263	18
	49,646	36,866	12,780	109,609	89,166	20,443
Other:						
Structured finance	33,337	59,669	(26,332)	68,136	112,117	(43,981)
Fixed income services	(3,015)	8,404	(11,419)	1,931	30,586	(28,655)
Other	29	728	(699)	2,325	614	1,711
	30,351	68,801	(38,450)	72,392	143,317	(70,925)
Total noninterest income	116,143	141,022	(24,879)	298,229	350,192	(51,963)
Net revenue ⁽²⁾	126,570	149,190	(22,620)	329,852	381,197	(51,345)
Noninterest expense:						
Variable compensation ⁽³⁾	53,505	60,774	(7,269)	125,325	145,169	(19,844)
Non-variable compensation and benefits ⁽⁵⁾	28,924	27,438	1,486	85,550	79,606	5,944
Segment operating costs ⁽⁴⁾⁽⁵⁾	26,720	25,579	1,141	77,033	75,066	1,967
Total noninterest expense	109,149	113,791	(4,642)	287,908	299,841	(11,933)
Income before income taxes	\$ 17,421	\$ 35,399	\$ (17,978)	\$ 41,944	\$ 81,356	\$ (39,412)

(1) Securities commissions and fees includes income of \$1.7 million and \$2.9 million during the three months ended September 30, 2021 and 2020, respectively, and \$5.2 million and \$10.9 million during nine months ended September 30, 2021 and 2020, respectively, that is eliminated in consolidation.

(2) Net revenue is defined as the sum of total net interest income and total noninterest income. We consider net revenue to be a key performance measure in the evaluation of the broker-dealer segment's financial position and operating performance as we believe it is the primary revenue performance measure used by investors and analysts. Net revenue provides for some level of comparability of trends across the financial services industry as it reflects both noninterest income, including investment and securities advisory fees and commissions, as well as net interest income. Internally, we assess the broker-dealer segment's performance on a revenue basis for comparability with our banking segment.

(3) Variable compensation represents performance-based commissions and incentives.

(4) Segment operating costs include provision for credit losses associated with the broker-dealer segment within other noninterest expenses.

(5) Noted balances during all prior periods include certain reclassifications to conform to current period presentation.

During the third quarter of 2021, the broker-dealer segment's structured finance and fixed income business lines both experienced a decline in net revenues. Structured finance net revenues declined compared to the third quarter of 2020 due to lower production volumes and less favorable market conditions. Fixed income services business line net revenues decreased, compared with the same period in 2020, primarily due to a decrease of \$11.4 million in net gains from trading activities. The increase in net revenues in the broker-dealer segment's public finance services and wealth management business lines partially offset these declines. The improvement in the public finance net revenue can primarily be attributed to improved underwriting revenues. Wealth management business line's net revenues were higher in the three months ended September 30, 2021, compared to the same period in 2020, from improved production and advisory fee income and higher interest income as a result of increased margin balances and correspondent receivables, despite lower money market and FDIC sweep revenues due to the low interest rate environment.

The decreases in the broker-dealer segment's income before income taxes during the three and nine months ended September 30, 2021 compared with the same periods in 2020, were primarily as a result of the following:

- decreases in the broker-dealer segment's structured finance net revenues as a result of lower volumes and a less robust market environment resulting in decreases in the business line's other noninterest income compared to the same periods in 2020.
- decreases in the broker-dealer segment's fixed income services net revenues primarily from declines in noninterest income compared to the same periods in 2020. For the three and nine months ended September 30, 2021, the broker-dealer segment experienced net revenue declines in each trading division as a result of less robust customer demand and a less favorable trading environment. Additionally, for the nine month comparable period, the decline also included a \$1.6 million decrease in net revenues due to the wind-down of the equity capital market division.
- decreases in compensation expense, of which \$7.3 million and \$19.8 million, respectively, was primarily due to the decrease in variable compensation associated with revenue declines in our structured finance and fixed income services 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 client transactions, which could be adversely impacted by interest rate volatility. 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.

In the broker-dealer segment, interest is earned from securities lending activities, interest charged on customer margin loan balances and interest earned on investment securities used to support sales, underwriting and other customer activities. The increase in net interest income during the three months ended September 30, 2021, compared with the same period in 2020, was primarily due to the increase in net interest income from our fixed income services business line and the net interest earned on customer margin loans. The slight increase in net interest income during the nine months ended September 30, 2021, compared with the same period in 2020, was primarily due to increases in net interest income from our fixed income services and securities lending division of our wealth management business line partially offset by a reduction in net interest income from securities owned and customer margin loans. With the 39 basis point decrease in the nine-month weighted average Federal Funds interest rate from September 30, 2020 to September 30, 2021, the amount of interest earned on customer investment activities decreased as well.

Noninterest income decreased during the three and nine months ended September 30, 2021, compared to the same periods in 2020, primarily due to decreases in other noninterest income, partially offset by the increases in securities commissions and fees and investment banking and advisory fees and commissions for the three months ended September 30, 2021 and partially offset by the increase in investment and securities advisory fees and commissions for the nine months ended September 30, 2021.

Securities commissions and fees increased during the three months ended September 30, 2021, compared with the same period in 2020, primarily due to increases in commissions earned in mutual fund, insurance product and commodities contract sales transactions. These increases were partially offset by a \$1.6 million decline in our money market and FDIC sweep revenues. Securities commissions and fees decreased during the nine months ended September 30, 2021, compared with the same period in 2020, primarily due to a decrease in commissions earned in our wealth management line of business given a \$9.5 million decline in our money market and FDIC sweep revenues given the lower interest rate environment, decreases in commissions earned from sales of OTC securities and our wind-down of the equity capital markets division. These decreases were partially offset by increases in commissions earned on mutual fund, insurance product and commodities contract sales transactions.

Investment and securities advisory fees and commissions increased during the three and nine months ended September 30, 2021, compared with the same periods in 2020, primarily due to increases in fees earned from our public finance fees received for municipal transactions and from improved wealth management advisory services fees.

Other noninterest income decreased during the three and nine months ended September 30, 2021, compared with the same periods in 2020, primarily due to decreases in trading gains earned from our structured finance business line's derivative activities due to decreased volumes and interest rate volatility. These year-over-year decreases in other noninterest income were heightened by decreases within our fixed income services business line within our taxable and municipal securities trading portfolios.

Noninterest expenses decreased during the three and nine months ended September 30, 2021, compared to the same periods in 2020, primarily due to decreases in variable compensation as previously noted, and for the nine months ended, partially offset by increased expenses in 2021 associated with the deployment of the new back-office system.

Selected information concerning the broker-dealer segment, including key performance indicators, follows (dollars in thousands).

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Total compensation as a % of net revenue ⁽¹⁾	65.1 %	59.1 %	63.9 %	59.0 %
Pre-tax margin ⁽²⁾	13.8 %	23.7 %	12.7 %	21.3 %
FDIC insured program balances at the Bank (end of period)			\$ 794,446	\$ 900,008
Other FDIC insured program balances (end of period)			\$ 1,594,069	\$ 1,683,981
Customer funds on deposit, including short credits (end of period)			\$ 506,582	\$ 419,078
Public finance services:				
Number of issues	283	340	908	936
Aggregate amount of offerings	\$ 14,832,192	\$ 15,174,488	\$ 45,450,987	\$ 41,352,113
Structured finance:				
Lock production/TBA volume	\$ 1,774,501	\$ 2,662,729	\$ 5,491,809	\$ 6,687,631
Fixed income services:				
Total volumes	\$ 53,254,804	\$ 52,496,966	\$ 184,280,307	\$ 105,941,044
Net inventory (end of period)			\$ 496,615	\$ 610,641
Wealth management (Retail and Clearing services groups):				
Retail employee representatives (end of period)			103	119
Independent registered representatives (end of period)			188	193
Correspondents (end of period)			122	130
Correspondent receivables (end of period)			\$ 271,664	\$ 243,480
Customer margin balances (end of period)			\$ 374,002	\$ 258,447
Wealth management (Securities lending group):				
Interest-earning assets - stock borrowed (end of period)			\$ 1,377,261	\$ 1,285,509
Interest-bearing liabilities - stock loaned (end of period)			\$ 1,350,722	\$ 1,177,098

- (1) Total compensation includes the sum of non-variable compensation and benefits and variable compensation. We consider total compensation as a percentage of net revenue to be a key performance measure and indicator of segment profitability.
- (2) Pre-tax margin is defined as income before income taxes divided by net revenue. We consider pre-tax margin to be a key performance measure given its use as a profitability metric representing the percentage of net revenue earned that results in a profit.

Mortgage Origination Segment

The following table presents certain information regarding the operating results of our mortgage origination segment (in thousands).

	<u>Three Months Ended September 30,</u>		<u>Variance</u>	<u>Nine Months Ended September 30,</u>		<u>Variance</u>
	<u>2021</u>	<u>2020</u>	<u>2021 vs 2020</u>	<u>2021</u>	<u>2020</u>	<u>2021 vs 2020</u>
Net interest income (expense)	\$ (3,503)	\$ (2,349)	\$ (1,154)	\$ (16,554)	\$ (3,647)	\$ (12,907)
Noninterest income	242,270	355,471	(113,201)	794,679	874,926	(80,247)
Noninterest expense	176,587	207,176	(30,589)	573,884	547,222	26,662
Income before income taxes	<u>\$ 62,180</u>	<u>\$ 145,946</u>	<u>\$ (83,766)</u>	<u>\$ 204,241</u>	<u>\$ 324,057</u>	<u>\$ (119,816)</u>

The mortgage lending business is subject to variables that can impact loan origination volume, including seasonal transaction volumes and interest rate fluctuations. Historically, the mortgage origination segment has experienced increased loan origination volume from purchases of homes during the spring and summer months, 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 mortgage interest rates have historically had a lesser impact on home purchases volume than on refinancing volume. See details regarding loan origination volume in the table below.

Recent trends, as well as typical historical patterns in loan origination volume from purchases of homes or from refinancings as a result of movements in mortgage interest rates, may not be indicative of future loan origination volumes given continued economic uncertainties stemming from the COVID-19 pandemic. The mortgage origination segment's business is dependent upon the willingness and ability of its employees and customers to conduct mortgage transactions. Current home inventory levels, affordability challenges, and supply chain problems related to new home construction have impacted customers' abilities to purchase homes. Home inventory shortages and affordability challenges present prior to 2020 were amplified by the economic impact of COVID-19, while supply chain problems can be more directly tied to COVID-19. The continuing impact of the COVID-19 pandemic on customers could have a material adverse effect on the operations of the mortgage origination segment. In addition, a further increase in mortgage interest rates and/or continuing home inventory shortages and supply chain issues related to new home construction could adversely affect loan origination volume and/or alter the percentage mix of refinancing and purchase volumes relative to total loan origination volume compared to 2020.

Since March 2020, economic uncertainties resulting from the spread of COVID-19 have had disruptive effects on the financial markets in which the mortgage origination segment operates as well as the global economy. In response to the COVID-19 pandemic, the U.S. 10 Year Treasury Rate declined significantly during the first quarter of 2020, which was followed by a steady decrease in mortgage interest rates during the remainder of 2020. Since December 2020, mortgage rates have increased, but remained lower on average during the nine months ended September 30, 2021, compared to the same period in 2020. As discussed in the "Recent Developments" section above, while the impact of the pandemic and the uncertainties have remained into 2021, significant progress associated with COVID-19 vaccination levels for U.S. residents has resulted in easing of restrictive measures in the United States. Further, the U.S. federal government has continued policies that have provided fiscal stimulus to the economy and relief to those affected by the pandemic.

Income before income taxes decreased during the three and nine months ended September 30, 2021, compared with the same period in 2020. These decreases were primarily the result of a decreases in interest rate lock commitments ("IRLCs") related to a decrease in mortgage loan applications, in addition to decreases in the average value of individual IRLCs.

The CARES Act has provided borrowers the ability to request forbearance of residential mortgage loan payments, placing a significant strain on mortgage servicers as they may be required to fund missed or deferred payments related to loans in forbearance. A significant increase in nationwide forbearance requests that began in March 2020 resulted in the reduction of third-party mortgage servicers willing to purchase mortgage servicing rights. As a result of this market dynamic, beginning in the second quarter of 2020, we increased the amount of retained servicing on mortgage loans sold, as discussed in more detail below. Beginning in the fourth quarter of 2020 and continuing into the third quarter of 2021, PrimeLending has reduced the amount of retained servicing. However, amounts retained during the third quarter of 2021 continued to exceed amounts retained prior to the second quarter of 2020. PrimeLending utilizes a third-party to manage its servicing portfolio, and we therefore do not expect significant fluctuations in infrastructure costs to manage changes in PrimeLending's servicing portfolio. PrimeLending's liquidity has not been, and we do not expect that it will be significantly impacted by forbearance requests resulting from the CARES Act. GNMA, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation may impose restrictions on loans the agencies will accept,

including loans under a forbearance agreement, which could result in PrimeLending seeking non-agency investors or choosing to retain these loans.

As average mortgage interest rates increased during the nine months ended September 30, 2021, compared to a decrease in rates during the same period in 2020, refinancing volume as a percentage of total origination volume decreased during both the three and nine months ended September 30, 2021, as compared to the same periods in 2020. Refinancing volume during the three months ended September 30, 2021, decreased to 29.4% from 35.1% during the same period in 2020, while refinancing volume during the nine months ended September 30, 2021, decreased slightly to 38.5% from 39.8% during the same period in 2020. If current mortgage interest rates remain relatively unchanged through December 31, 2021, we anticipate a lower percentage of refinancing volume relative to total loan origination volume during the last quarter of 2021 as compared to the last quarter of 2020. However, a higher refinance percentage could be driven by a slowing of purchase volume due to the negative impact on new and existing home sales resulting from existing home inventory shortages, affordability challenges, and supply chain problems related to new home construction.

The mortgage origination segment primarily originates its mortgage loans through a retail channel, with limited lending through its affiliated business arrangements (“ABAs”). For the nine months ended September 30, 2021, funded volume through ABAs was approximately 5% of the mortgage origination segment’s total loan volume. As of September 30, 2021, PrimeLending owned a greater than 50% membership interest in three ABAs. We expect total production within the ABA channel to increase slightly to approximately 6% of loan volume of the mortgage origination segment during the remainder of 2021.

The following table provides further details regarding our mortgage loan originations and sales for the periods indicated below (dollars in thousands).

	Three Months Ended September 30,				Variance 2021 vs 2020	Nine Months Ended September 30,				Variance 2021 vs 2020
	2021		2020			2021		2020		
	Amount	% of Total	Amount	% of Total		Amount	% of Total	Amount	% of Total	
Mortgage Loan Originations - units	18,919		23,673		(4,754)	60,651		59,802		849
Mortgage Loan Originations - volume:										
Conventional	\$ 3,871,765	69.20 %	\$ 4,844,635	75.11 %	\$ (972,870)	\$ 12,410,492	70.20 %	\$ 11,426,726	70.66 %	\$ 983,766
Government	894,869	16.00 %	1,225,055	18.99 %	(330,186)	2,571,494	14.54 %	3,547,353	21.94 %	(975,859)
Jumbo	547,131	9.78 %	189,518	2.94 %	357,613	1,986,473	11.24 %	650,992	4.03 %	1,335,481
Other	280,863	5.02 %	191,145	2.96 %	89,718	710,318	4.02 %	546,929	3.37 %	163,389
	<u>\$ 5,594,628</u>	<u>100.00 %</u>	<u>\$ 6,450,353</u>	<u>100.00 %</u>	<u>\$ (855,725)</u>	<u>\$ 17,678,777</u>	<u>100.00 %</u>	<u>\$ 16,172,000</u>	<u>100.00 %</u>	<u>\$ 1,506,777</u>
Home purchases	\$ 3,948,420	70.58 %	\$ 4,183,560	64.86 %	\$ (235,140)	\$ 10,870,052	61.49 %	\$ 9,729,981	60.17 %	\$ 1,140,071
Refinancings	1,646,208	29.42 %	2,266,793	35.14 %	(620,585)	6,808,725	38.51 %	6,442,019	39.83 %	366,706
	<u>\$ 5,594,628</u>	<u>100.00 %</u>	<u>\$ 6,450,353</u>	<u>100.00 %</u>	<u>\$ (855,725)</u>	<u>\$ 17,678,777</u>	<u>100.00 %</u>	<u>\$ 16,172,000</u>	<u>100.00 %</u>	<u>\$ 1,506,777</u>
Texas	\$ 1,066,264	19.06 %	\$ 1,223,544	18.97 %	\$ (157,280)	\$ 3,237,241	18.31 %	\$ 3,078,700	19.04 %	\$ 158,541
California	625,715	11.18 %	640,081	9.92 %	(14,366)	2,151,196	12.17 %	1,656,438	10.24 %	494,758
Arizona	249,471	4.46 %	278,065	4.31 %	(28,594)	806,722	4.56 %	729,920	4.51 %	76,802
Florida	240,413	4.30 %	419,537	6.50 %	(179,124)	793,293	4.49 %	1,123,061	6.94 %	(329,768)
South Carolina	219,394	3.92 %	257,531	3.99 %	(38,137)	744,834	4.21 %	654,840	4.05 %	89,994
Ohio	226,164	4.04 %	255,388	3.96 %	(29,224)	676,395	3.83 %	617,369	3.82 %	59,026
Missouri	205,897	3.68 %	232,253	3.60 %	(26,356)	574,878	3.25 %	557,772	3.45 %	17,106
Washington	177,118	3.17 %	199,425	3.09 %	(22,307)	568,911	3.22 %	505,782	3.13 %	63,129
North Carolina	159,894	2.86 %	186,522	2.89 %	(26,628)	578,796	3.27 %	493,161	3.05 %	85,635
Maryland	134,655	2.41 %	229,705	3.56 %	(95,050)	524,645	2.97 %	580,487	3.59 %	(55,842)
All other states	2,289,643	40.92 %	2,528,302	39.21 %	(238,659)	7,021,866	39.72 %	6,174,470	38.18 %	847,396
	<u>\$ 5,594,628</u>	<u>100.00 %</u>	<u>\$ 6,450,353</u>	<u>100.00 %</u>	<u>\$ (855,725)</u>	<u>\$ 17,678,777</u>	<u>100.00 %</u>	<u>\$ 16,172,000</u>	<u>100.00 %</u>	<u>\$ 1,506,777</u>
Mortgage Loan Sales - volume:										
Third parties	\$ 5,967,850	96.32 %	\$ 6,508,983	99.80 %	\$ (541,133)	\$ 17,503,092	96.86 %	\$ 15,787,591	99.03 %	\$ 1,715,501
Banking segment	227,709	3.68 %	12,790	0.20 %	214,919	567,530	3.14 %	155,345	0.97 %	412,185
	<u>\$ 6,195,559</u>	<u>100.00 %</u>	<u>\$ 6,521,773</u>	<u>100.00 %</u>	<u>\$ (326,214)</u>	<u>\$ 18,070,622</u>	<u>100.00 %</u>	<u>\$ 15,942,936</u>	<u>100.00 %</u>	<u>\$ 2,127,686</u>

We consider the mortgage origination segment’s total loan origination volume to be a key performance measure. Loan origination volume is central to the segment’s ability to generate income by originating and selling mortgage loans, resulting in net gains from the sale of loans, mortgage loan origination fees, and other mortgage production income. Total loan origination volume is a measure utilized by management, our investors and analysts in assessing market share and growth of the mortgage origination segment.

The mortgage origination segment's total loan origination volume during the three and nine months ended September 30, 2021, decreased 13.3% and increased 9.3% compared to the same periods in 2020, respectively, while income before income taxes decreased 57.4% and 37.0%, respectively, during the same periods in 2020. The decrease in income before income taxes during the three and nine months ended September 30, 2021, was primarily the result of a decrease of IRLCs related to a decrease in mortgage loan applications, and a decrease in the average value of individual IRLCs. Also contributing to the decrease during the nine months ended September 30, 2021, was an increase in variable compensation primarily driven by an increase in loan origination volume.

The information shown in the table below includes certain key performance indicators for the mortgage origination segment.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Net gains from mortgage loan sales (basis points):				
Loans sold to third parties	359	441	378	392
Impact of loans retained by banking segment	(13)	(1)	(12)	(4)
As reported	346	440	366	388
Variable compensation as a percentage of total compensation	65.4 %	71.9 %	67.4 %	68.2 %
Mortgage servicing rights asset (\$000's) (end of period) ⁽¹⁾			\$ 110,931	\$ 127,712

(1) Reported on a consolidated basis and therefore does not include mortgage servicing rights assets related to loans serviced for the banking segment, which are eliminated in consolidation.

Net interest expense during the three and nine months ended September 30, 2021 and 2020 was comprised of interest income earned on loans held for sale offset by interest incurred on warehouse lines of credit primarily held with the Bank, and related intercompany financing costs. The decrease in net interest expense during the three and nine months ended September 30, 2021 and 2020 included the effects of decreased net yields on mortgage loans held for sale between the two periods.

Noninterest income was comprised of the items set forth in the table below (in thousands).

	Three Months Ended September 30,		Variance	Nine Months Ended September 30,		Variance
	2021	2020	2021 vs 2020	2021	2020	2021 vs 2020
Net gains from sale of loans	\$ 214,093	\$ 287,255	\$ (73,162)	\$ 661,563	\$ 618,846	\$ 42,717
Mortgage loan origination fees and other related income	38,780	47,703	(8,923)	124,082	121,841	2,241
Other mortgage production income:						
Change in net fair value and related derivative activity:						
IRLCs and loans held for sale	(22,902)	22,466	(45,368)	(47,274)	136,409	(183,683)
Mortgage servicing rights asset	(3,306)	(12,301)	8,995	8,379	(23,511)	31,890
Servicing fees	15,605	10,348	5,257	47,929	21,341	26,588
Total noninterest income	\$ 242,270	\$ 355,471	\$ (113,201)	\$ 794,679	\$ 874,926	\$ (80,247)

The decrease in net gains from sale of loans during the three months ended September 30, 2021, compared with the same period in 2020, was primarily a result of a decrease in average loan sales margin, and to a lesser extent a decrease in total loan sales volume. The increase in net gains from sale of loans during the nine months ended September 30, 2021, compared with the same period in 2020, was primarily a result of an increase in total loan sales volume, partially offset by a decrease in average loan sales margin. Since PrimeLending sells substantially all mortgage loans it originates to various investors in the secondary market, the increase in loan sales volume during the nine months ended September 30, 2021, is consistent with the increase in loan origination volume during the period. The decreases in average loan sales margins during both the three and nine months ended September 30, 2021, were primarily attributable to competitive pricing pressure resulting from home inventory shortages and a reduction in national refinancing volume. While average loan sales margins increased between the second and fourth quarters of 2020, margins have steadily declined during the nine months ended September 30, 2021, approaching margins recognized at the beginning of the COVID-19 pandemic. The decrease in mortgage loan origination fees during the three months ended September 30, 2021, compared with the same period in 2020, was primarily the result of a decrease in loan origination volume, in addition to a decrease in average mortgage loan origination fees.

We consider the mortgage origination segment's net gains from sale of loans margin, in basis points, to be a key performance measure. Net gains from sale of loans margin is defined as net gains from sale of loans divided by loan sales volume. The net gains from sale of loans is central to the segment's generation of income, and may include loans sold to third parties and loans sold to and retained by the banking segment. For origination services provided, the mortgage origination segment was reimbursed direct origination costs associated with loans retained by the banking

segment, in addition to payment of a correspondent fee. The reimbursed origination costs and correspondent fee are included in the mortgage origination segment operating results, and the correspondent fees are eliminated in consolidation. Loan volumes to be originated on behalf of and retained by the banking segment are evaluated each quarter. While we anticipate an increase in loans sold to and retained by the banking segment during the remainder of 2021 and then leveling off in 2022, we do not expect these sales to exceed 5% of total origination volume during this time. Loan volumes to be originated on behalf of and retained by the banking segment are evaluated each quarter, and recent trends may not be indicative of sales during 2022. In March 2020, the mortgage origination segment executed a letter of intent with the banking segment to purchase mortgage loans previously sold to and retained by the banking segment with an unpaid principal balance of approximately \$210 million. Such original sales of approximately \$121 million are reflected in the previous mortgage loan details table within the mortgage loan sales volume to the banking segment during the nine months ended September 30, 2020. The remaining \$91 million of such original sales were sold to the banking segment during 2019. When these loans were sold at par by the mortgage origination segment, the banking segment's intent was to hold these loans for investment. The mortgage origination segment completed the repurchase of these loans from the banking segment and in turn sold the loans to investors in the secondary market during the second quarter of 2020.

Noninterest income included changes in the net fair value of the mortgage origination segment's IRLCs and loans held for sale and the related activity associated with forward commitments used by the mortgage origination segment to mitigate interest rate risk associated with its IRLCs and mortgage loans held for sale. The decrease in fair value of IRLCs and loans held for sale during the three and nine months ended September 30, 2021 was the result of decreases in the total volume of individual IRLCs and loans held for sale and the average value of individual IRLCs and loans held for sale.

The mortgage origination segment sells substantially all mortgage loans it originates to various investors in the secondary market, historically with the majority servicing released. In addition, the mortgage origination segment originates loans on behalf of the Bank. The mortgage origination segment'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. During the three months ended September 30, 2021, PrimeLending retained servicing on 24% of loans sold. Beginning in the second quarter of 2020, we increased the amount of retained servicing on mortgage loan sales. During both the second and third quarters of 2020, PrimeLending retained servicing on 89% of total mortgage loans sold. The increase in rates of retained servicing during this time was due to the reduction in third-party servicing outlets during the second quarter of 2020 resulting from the impact of the CARES Act. The CARES Act permits borrowers of federally-backed mortgage loans to forbear payments, which could negatively impact servicers' liquidity and their ability to purchase servicing. As forbearance requests leveled off during the latter part of 2020, the third-party market for mortgage servicing rights improved, increasing demand, which allowed PrimeLending to reduce retained servicing to 57% of total mortgage loans sold during the fourth quarter of 2020, then to 34% of total mortgage loans sold during the nine months ended September 30, 2021. If the third-party market for mortgage servicing rights continue to improve after year-end, we expect that PrimeLending will continue to reduce retained servicing on mortgage loans sold during 2022. The mortgage origination segment may, from time to time, manage its MSR asset through different strategies, including varying the percentage of mortgage loans sold servicing released and opportunistically selling MSR assets. The mortgage origination segment has also retained servicing on certain loans sold to and retained by the banking segment. Gains and losses associated with such sales to the banking segment and the related MSR asset are eliminated in consolidation. The mortgage origination segment uses derivative financial instruments, including U.S. Treasury bond futures and options, as a means to mitigate interest rate risk associated with its MSR asset. Changes in the net fair value of the MSR asset and the related derivatives associated with normal customer payments, changes in discount rates, prepayment speed assumptions and customer payoffs resulted in net gains (losses) as noted in the table above. Included in the net gains and losses for the three and nine months ended September 30, 2021, are MSR asset fair value adjustment gains totaling \$3.3 million and \$22.2 million, respectively, which reflect the difference between the MSR asset carrying values and the sale prices reflected in the letters of intent to sell the applicable MSR assets. On March 31 and June 30, 2021, the mortgage origination segment sold MSR assets of \$52.8 million, which represented \$4.9 billion of its serviced loan volume at the time, and \$31.5 million, which represented \$2.6 billion of its serviced loan volume at the time, respectively. As of September 30, 2021, the mortgage origination segment had executed a letter of intent for a pending sale of MSR assets with a serviced loan volume totaling \$750 million. The sale of these MSR assets is expected to be completed during the fourth quarter of 2021, at a total price of approximately \$9.6 million. On October 8, 2021, the mortgage origination segment executed a letter of intent for a pending sale of MSR assets with a serviced loan volume totaling \$1.9 billion. The sale of these MSR assets is expected to be completed during the fourth quarter of 2021, at a total price of approximately \$21.0 million. The value assigned these MSR assets as of September 30, 2021, reflects the price included in this letter of intent.

Noninterest expenses were comprised of the items set forth in the table below (in thousands).

	<u>Three Months Ended September 30,</u>		<u>Variance</u>	<u>Nine Months Ended September 30,</u>		<u>Variance</u>
	<u>2021</u>	<u>2020</u>	<u>2021 vs 2020</u>	<u>2021</u>	<u>2020</u>	<u>2021 vs 2020</u>
Variable compensation	\$ 88,153	\$ 116,275	\$ (28,122)	\$ 300,720	\$ 288,380	\$ 12,340
Non-variable compensation and benefits	46,661	45,463	1,198	145,743	134,511	11,232
Segment operating costs	28,869	33,414	(4,545)	88,657	94,062	(5,405)
Lender paid closing costs	4,940	6,227	(1,287)	15,321	17,145	(1,824)
Servicing expense	7,964	5,797	2,167	23,443	13,124	10,319
Total noninterest expense	<u>\$ 176,587</u>	<u>\$ 207,176</u>	<u>\$ (30,589)</u>	<u>\$ 573,884</u>	<u>\$ 547,222</u>	<u>\$ 26,662</u>

Total employees' compensation and benefits accounted for the majority of noninterest expenses incurred during all periods presented. Specifically, as previously noted, variable compensation comprised a significant portion of total employees' compensation and benefits expenses during the three and nine months ended September 30, 2021 and 2020. The decreases in the percentage concentration of variable compensation and benefits between the three and nine months ended September 30, 2021 and 2020, were primarily due to decreases in the average incentive rate paid and the impact of incentive plans driven by non-mortgage production criteria. Variable compensation, which is primarily driven by loan origination volume, tends to fluctuate to a greater degree than loan origination volume, because mortgage loan originator and fulfillment staff incentive compensation plans are structured to pay at increasing rates as higher monthly volume tiers are achieved. However, certain other incentive compensation plans driven by non-mortgage production criteria may alter this trend.

While total loan origination volume decreased 13.3% and increased 9.3%, during the three and nine months ended September 30, 2021, compared to the same periods in 2020, respectively, the aggregate non-variable compensation and benefits of the mortgage origination segment increased 2.6% and 8.4%, compared to the same periods in 2020, respectively. The increase during the nine months ended September 30, 2021, was primarily due to an increase in salaries mainly resulting from increased underwriting and loan fulfillment staff to support the increase in loan origination volume starting in the second quarter of 2020. These additional staff continued to be needed to support loan origination volumes during the remainder of 2020 and the first nine months of 2021. Segment operating costs decreased during the three and nine months ended September 30, 2021, compared to the same periods in 2020, primarily due to decreases in software amortization expense and software license and maintenance costs.

In exchange for a higher interest rate, customers may opt to have PrimeLending pay certain costs associated with the origination of their mortgage loans ("lender paid closing costs"). Fluctuations in lender paid closing costs are not always aligned with fluctuations in loan origination volume. Other loan pricing conditions, including the mortgage loan interest rate, loan origination fees paid by the customer, and a customer's willingness to pay closing costs, may influence fluctuations in lender paid closing costs.

Between January 1, 2012 and September 30, 2021, the mortgage origination segment sold mortgage loans totaling \$146.9 billion. These loans were sold under sales contracts that generally include provisions that hold the mortgage origination segment responsible for errors or omissions relating to its representations and warranties that loans sold meet certain requirements, including representations as to underwriting standards and the validity of certain borrower representations in connection with the loan. In addition, the sales contracts typically require the refund of purchased servicing rights plus certain investor servicing costs if a loan experiences an early payment default. While the mortgage origination segment sold loans prior to 2012, it does not anticipate experiencing significant losses in the future on loans originated prior to 2012 as a result of investor claims under these provisions of its sales contracts.

When a claim for indemnification of a loan sold is made by an agency, investor, or other party, the mortgage origination segment evaluates the claim and determines if the claim can be satisfied through additional documentation or other deliverables. If the claim is valid and cannot be satisfied in that manner, the mortgage origination segment negotiates with the claimant to reach a settlement of the claim. Settlements typically result in either the repurchase of a loan or reimbursement to the claimant for losses incurred on the loan.

Following is a summary of the mortgage origination segment's claims resolution activity relating to loans sold between January 1, 2012 and September 30, 2021 (dollars in thousands).

	Original Loan Balance		Loss Recognized	
	Amount	% of Loans Sold	Amount	% of Loans Sold
Claims resolved with no payment	\$ 208,929	0.14 %	\$ —	0.00 %
Claims resolved because of a loan repurchase or payment to an investor for losses incurred ⁽¹⁾	231,263	0.16 %	9,055	0.01 %
	<u>\$ 440,192</u>	<u>0.30 %</u>	<u>\$ 9,055</u>	<u>0.01 %</u>

(1) Losses incurred include refunded purchased servicing rights.

For each loan the mortgage origination segment concludes its obligation to a claimant is both probable and reasonably estimable, the mortgage origination segment has established a specific claims indemnification liability reserve. An additional indemnification liability reserve has been established for probable agency, investor or other party losses that may have been incurred, but not yet reported to the mortgage origination segment based upon a reasonable estimate of such losses. In addition to other factors, the mortgage origination segment has considered that GNMA, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation have imposed certain restrictions on loans the agencies will accept under a forbearance agreement resulting from the COVID-19 pandemic, which could increase the magnitude of indemnification losses on these loans.

At September 30, 2021 and December 31, 2020, the mortgage origination segment's total indemnification liability reserve totaled \$26.0 million and \$21.5 million, respectively. The related provision for indemnification losses was \$2.5 million and \$3.1 million during the three months ended September 30, 2021 and 2020, respectively, and \$8.0 million and \$7.7 million during the nine months ended September 30, 2021 and 2020, respectively.

Corporate

The following table presents certain financial information regarding the operating results of corporate (in thousands).

	Three Months Ended September 30,		Variance 2021 vs 2020	Nine Months Ended September 30,		Variance 2021 vs 2020
	2021	2020		2021	2020	
Net interest income (expense)	\$ (4,341)	\$ (4,594)	\$ 253	\$ (13,720)	\$ (9,482)	\$ (4,238)
Noninterest income	757	477	280	8,140	3,315	4,825
Noninterest expense	15,355	21,999	(6,644)	37,015	35,741	1,274
Income (loss) from continuing operations before income taxes	<u>\$ (18,939)</u>	<u>\$ (26,116)</u>	<u>\$ 7,177</u>	<u>\$ (42,595)</u>	<u>\$ (41,908)</u>	<u>\$ (687)</u>

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

As a holding company, Hilltop's primary investment objectives are to support capital deployment for organic growth and to preserve capital to be deployed through acquisitions, dividend payments and potential stock repurchases. Investment and interest income earned during the three and nine months ended September 30, 2021 was primarily comprised of dividend income from merchant banking investment activities, in addition to interest income earned on intercompany notes.

Interest expense during each period included recurring quarterly interest expense of \$1.9 million incurred on our \$150.0 million aggregate principal amount of 5% senior notes due 2025 ("Senior Notes"). During the three months ended September 30, 2021 and 2020, we incurred interest expense of \$3.1 million and \$3.1 million, respectively, and \$9.3 million and \$4.8 million during the nine months ended September 30, 2021 and 2020, respectively, on our \$200 million aggregate principal amount of Subordinated Notes, which were issued in May 2020. Additionally, we incurred interest expense of \$0.4 million and \$0.6 million during the three months ended September 30, 2021 and 2020, respectively, and \$1.6 million and \$2.2 million during the nine months ended September 30, 2021 and 2020, respectively, on junior subordinated debentures of \$67.0 million issued by PCC (the "Debentures"). As discussed in more detail within the

section titled “Liquidity and Capital Resources — Junior Subordinated Debentures” below, during the third quarter of 2021, PCC fully redeemed all outstanding Debentures.

Noninterest income from continuing operations during each period included activity related to our investment in a real estate development in Dallas’ University Park, which also serves as headquarters for both Hilltop and the Bank, and net noninterest income associated with activity within our merchant bank subsidiary. During the nine months ended September 31, 2021, noninterest income included an aggregate of \$6.5 million in pre-tax gains associated with observable transactions related to two merchant bank equity investments.

Noninterest expenses from continuing operations were primarily comprised of employees’ compensation and benefits, occupancy expenses and professional fees, including corporate governance, legal and transaction costs. Noninterest expenses decreased during the three months ended September 30, 2021, compared to the same period in 2020, primarily due to decreases in expenses associated with employees’ incentive compensation and professional fees.

Results from Discontinued Operations

Insurance Segment

As previously discussed, on June 30, 2020, we completed the sale of NLC. Accordingly, insurance segment results for the three and nine months ended September 30, 2020 have been presented as discontinued operations in the consolidated financial statements. Additional details are presented in Note 3, Discontinued Operations, in the notes to our consolidated financial statements. All activity associated with the insurance segment was recognized in 2020, therefore, there are no results in the three and nine months ended September 30, 2021. There was no income from discontinued operations before income taxes during the three months ended September 30, 2020, while income from discontinued operations before income taxes was \$2.1 million during the nine months ended September 30, 2020.

Corporate

As a result of the previously noted sale of NLC on June 30, 2020 for cash proceeds of \$154.1 million, during 2020, Hilltop recognized an aggregate pre-tax gain on sale within discontinued operations of corporate of \$36.8 million, net of customary transaction costs of \$5.1 million. The resulting book gain from this sale transaction was not recognized for tax purposes pursuant to the rules under the Internal Revenue Code. Income from discontinued operations before income taxes associated with corporate was \$0.7 million and \$33.1 million during the three and nine months ended September 30, 2020.

Financial Condition

The following discussion contains a more detailed analysis of our financial condition at September 30, 2021, as compared with December 31, 2020.

Securities Portfolio

At September 30, 2021, investment securities consisted of securities of the U.S. Treasury, U.S. government and its agencies, obligations of municipalities and other political subdivisions, primarily in the State of Texas, as well as mortgage-backed, corporate debt, and equity securities. We may categorize investments as trading, available for sale, held to maturity and equity securities.

Trading securities are bought and held principally for the purpose of selling them in the near term and are carried at fair value, marked to market through operations and held at the Bank and the Hilltop Broker-Dealers. Securities classified as available for sale may, from time to time, be bought and sold in response to changes in market interest rates, changes in securities’ prepayment risk, increases in loan demand, general liquidity needs and to take advantage of market conditions that create more economically attractive returns. Such securities are carried at estimated fair value, with unrealized gains and losses recorded in accumulated other comprehensive income (loss). Equity investments are carried at fair value, with all changes in fair value recognized in net income. Securities are classified as held to maturity based on the intent and ability of our management, at the time of purchase, to hold such securities to maturity. These securities are carried at amortized cost.

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

	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Trading securities, at fair value		
U.S. Treasury securities	\$ 3,401	\$ 40,491
U.S. government agencies:		
Bonds	14,883	40
Residential mortgage-backed securities	196,241	336,081
Commercial mortgage-backed securities	—	876
Collateralized mortgage obligations	54,065	69,172
Corporate debt securities	72,029	62,481
States and political subdivisions	264,044	171,573
Private-label securitized product	177	8,571
Other	4,973	4,970
	<u>609,813</u>	<u>694,255</u>
Securities available for sale, at fair value		
U.S. Treasury securities	4,956	—
U.S. government agencies:		
Bonds	46,119	82,806
Residential mortgage-backed securities	904,257	641,611
Commercial mortgage-backed securities	197,637	124,538
Collateralized mortgage obligations	794,009	565,908
States and political subdivisions	47,205	47,342
	<u>1,994,183</u>	<u>1,462,205</u>
Securities held to maturity, at amortized cost		
U.S. government agencies:		
Residential mortgage-backed securities	10,755	13,547
Commercial mortgage-backed securities	150,060	152,820
Collateralized mortgage obligations	48,210	74,932
States and political subdivisions	68,394	70,645
	<u>277,419</u>	<u>311,944</u>
Equity securities, at fair value	<u>221</u>	<u>140</u>
Total securities portfolio	<u>\$ 2,881,636</u>	<u>\$ 2,468,544</u>

We had net unrealized losses of \$2.8 million and net unrealized gains of \$26.3 million at September 30, 2021 and December 31, 2020, respectively, related to the available for sale investment portfolio, and net unrealized gains of \$10.7 million and \$14.7 million associated with the securities held to maturity portfolio at September 30, 2021 and December 31, 2020, respectively. Equity securities included net unrealized gains of \$0.2 million and \$0.1 million at September 30, 2021 and December 31, 2020.

Banking Segment

The banking segment's securities portfolio plays a role in the management of our interest rate sensitivity and generates additional interest income. In addition, the securities portfolio is used to meet collateral requirements for public and trust deposits, securities sold under agreements to repurchase and other purposes. The available for sale and equity securities portfolios serve as a source of liquidity. Historically, the Bank's policy has been to invest primarily in securities of the U.S. government and its agencies, obligations of municipalities in the State of Texas and other high grade fixed income securities to minimize credit risk. At September 30, 2021, the banking segment's securities portfolio of \$2.3 billion was comprised of trading securities of \$0.1 million, available for sale securities of \$2.0 billion, equity securities of \$0.2 million and held to maturity securities of \$277.4 million, in addition to \$14.3 million of other investments included in other assets within the consolidated balance sheets.

Broker-Dealer Segment

The broker-dealer segment holds securities to support sales, underwriting and other customer activities. The interest rate risk inherent in holding these securities is managed by setting and monitoring limits on the size and duration of positions and on the length of time the securities can be held. The Hilltop Broker-Dealers are required to carry their securities at fair value and record changes in the fair value of the portfolio in operations. Accordingly, the securities portfolio of the

Hilltop Broker-Dealers included trading securities of \$609.7 million at September 30, 2021. In addition, the Hilltop Broker-Dealers enter into transactions that represent commitments to purchase and deliver securities at prevailing future market prices to facilitate customer transactions and satisfy such commitments. Accordingly, the Hilltop Broker-Dealers' ultimate obligation may exceed the amount recognized in the financial statements. These securities, which are carried at fair value and reported as securities sold, not yet purchased in the consolidated balance sheets, had a value of \$113.1 million at September 30, 2021.

Corporate

At September 30, 2021, the corporate portfolio included other investments, including those associated with merchant banking, of \$29.1 million in other assets within the consolidated balance sheets.

Allowance for Credit Losses for Available for Sale Securities and Held to Maturity Securities

We have evaluated available for sale debt securities that are in an unrealized loss position and have determined that any declines in value are unrelated to credit loss and related to changes in market interest rates since purchase. None of the available for sale debt securities held were past due at September 30, 2021. In addition, as of September 30, 2021, we had evaluated our held to maturity debt securities, considering the current credit ratings and recognized losses, and determined the potential credit loss to be minimal. With respect to these securities, we considered the risk of credit loss to be negligible, and therefore, no allowance was recognized on the debt securities portfolio at September 30, 2021.

Loan Portfolio

Consolidated loans held for investment are detailed in the tables below, classified by portfolio segment.

	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Commercial real estate	\$ 3,032,141	\$ 3,133,903
Commercial and industrial	1,950,797	2,627,774
Construction and land development.	789,693	828,852
1-4 family residential	1,104,847	629,938
Consumer.	29,547	35,667
Broker-dealer.	<u>645,901</u>	<u>437,007</u>
Loans held for investment, gross	7,552,926	7,693,141
Allowance for credit losses	<u>(109,512)</u>	<u>(149,044)</u>
Loans held for investment, net of allowance . . .	<u>\$ 7,443,414</u>	<u>\$ 7,544,097</u>

Banking Segment

The loan portfolio constitutes the primary earning asset of the banking segment and typically offers the best alternative for obtaining the maximum interest spread above the banking segment's cost of funds. The overall economic strength of the banking segment generally parallels the quality and yield of its loan portfolio.

The banking segment's total loans held for investment, net of the allowance for credit losses, were \$8.6 billion and \$9.6 billion at September 30, 2021 and December 31, 2020, respectively. The banking segment's loan portfolio includes warehouse lines of credit extended to PrimeLending of \$3.3 billion, of which \$1.8 billion and \$2.5 billion was drawn at September 30, 2021 and December 31, 2020, respectively. Amounts advanced against the warehouse lines of credit are eliminated from net loans held for investment on our consolidated balance sheets. The banking segment does not generally participate in syndicated loan transactions and has no foreign loans in its portfolio.

The banking segment's loan portfolio included approximately \$133 million related to both initial and second round PPP loans at September 30, 2021. While these loans have terms of up to 60 months, borrowers can apply for forgiveness of these loans with the SBA. Through October 22, 2021, the SBA had approved approximately 3,300 initial and second round PPP forgiveness applications from the Bank totaling approximately \$775 million, with PPP loans of approximately \$12 million pending SBA review and approval. We anticipate a significant amount of these remaining PPP loans pending approval being forgiven over the next two quarters. The forgiveness/payoff of the PPP loans would generate an increase in interest income as we would recognize the remaining unamortized origination fee at the time of payoff or forgiveness.

At September 30, 2021, the banking segment had loan concentrations (loans to borrowers engaged in similar activities) that exceeded 10% of total loans in its real estate portfolio. The areas of concentration within our real estate portfolio were non-construction commercial real estate loans, non-construction residential real estate loans, and construction and land development loans, which represented 43.9%, 16.0% and 11.4%, respectively, of the banking segment's total loans held investment at September 30, 2021. The banking segment's loan concentrations were within regulatory guidelines at September 30, 2021.

Broker-Dealer Segment

The loan portfolio of the broker-dealer segment consists primarily of margin loans to customers and correspondents. These loans are collateralized by the securities purchased or by other securities owned by the clients and, because of collateral coverage ratios, are believed to present minimal collectability exposure. Additionally, these loans are subject to a number of regulatory requirements as well as the Hilltop Broker-Dealers' internal policies. The broker-dealer segment's total loans held for investment, net of the allowance for credit losses, were \$645.6 million and \$436.8 million at September 30, 2021 and December 31, 2020, respectively. This increase from December 31, 2020 to September 30, 2021 was primarily attributable to an increase of \$91.5 million, or 51%, in receivables from correspondents, and an increase of \$117.3 million, or 46%, in customer margin accounts.

Mortgage Origination Segment

The loan portfolio of the mortgage origination segment consists of loans held for sale, primarily single-family residential mortgages funded through PrimeLending, and IRLCs with customers pursuant to which we agree to originate a mortgage loan on a future date at an agreed-upon interest rate. The components of the mortgage origination segment's loans held for sale and IRLCs are as follows (in thousands).

	<u>September 30, 2021</u>	<u>December 31, 2020</u>
Loans held for sale:		
Unpaid principal balance.....	\$ 1,846,578	\$ 2,411,626
Fair value adjustment.....	54,567	109,778
	<u>\$ 1,901,145</u>	<u>\$ 2,521,404</u>
IRLCs:		
Unpaid principal balance.....	\$ 2,061,068	\$ 2,470,013
Fair value adjustment.....	40,279	76,048
	<u>\$ 2,101,347</u>	<u>\$ 2,546,061</u>

The mortgage origination segment uses forward commitments to mitigate interest rate risk associated with its loans held for sale and IRLCs. The notional amounts of these forward commitments at September 30, 2021 and December 31, 2020 were \$3.2 billion and \$4.0 billion, while the related estimated fair values were \$8.4 million and (\$28.0) million, respectively.

Allowance for Credit Losses on Loans

For additional information regarding the allowance for credit losses, refer to the section captioned "Critical Accounting Policies and Estimates" set forth in Part II, Item 7 of our 2020 Form 10-K.

Loans Held for Investment

The Bank has lending policies in place with the goal of establishing an asset portfolio that will provide a return on stockholders' equity sufficient to maintain capital to assets ratios that meet or exceed established regulations. Loans are underwritten with careful consideration of the borrower's financial condition, the specific purpose of the loan, the primary sources of repayment and any collateral pledged to secure the loan.

Underwriting procedures address financial components based on the size and complexity of the credit. The financial components include, but are not limited to, current and projected cash flows, shock analysis and/or stress testing, and trends in appropriate balance sheet and statement of operations ratios. The Bank's loan policy provides specific underwriting guidelines by portfolio segment, including commercial and industrial, real estate, construction and land

development, and consumer loans. The guidelines for each individual portfolio segment set forth permissible and impermissible loan types. With respect to each loan type, the guidelines within the Bank's loan policy provide minimum requirements for the underwriting factors listed above. The Bank's underwriting procedures also include an analysis of any collateral and guarantor. Collateral analysis includes a complete description of the collateral, as well as determined values, monitoring requirements, loan to value ratios, concentration risk, appraisal requirements and other information relevant to the collateral being pledged. Guarantor analysis includes liquidity and cash flow evaluation based on the significance with which the guarantors are expected to serve as secondary repayment sources.

The Bank maintains a loan review department that reviews credit risk in response to both external and internal factors that potentially impact the performance of either individual loans or the overall loan portfolio. The loan review process reviews the creditworthiness of borrowers and determines compliance with the loan policy. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel. Results of these reviews are presented to management, the Bank's board of directors and the Risk Committee of the board of directors of the Company.

The allowance for credit losses for loans held for investment represents management's best estimate of all expected credit losses over the expected contractual life of our existing portfolio. Determining the appropriateness of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the then-existing loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for credit losses in those future periods. Such future changes in the allowance for credit losses are expected to be volatile given dependence upon, among other things, the portfolio composition and quality, as well as the impact of significant drivers, including prepayment assumptions and macroeconomic conditions and forecasts.

The COVID-19 pandemic disrupted financial markets and overall economic conditions that have affected borrowers across our lending portfolios. Significant judgment is required to estimate the severity and duration of the current economic uncertainties, as well as its potential impact on borrower defaults and loss severity. In particular, macroeconomic conditions and forecasts are rapidly changing and remain highly uncertain as COVID-19 cases and vaccine effectiveness, as well as government stimulus and policy measures, evolve nationally and in key geographies. It is difficult to predict exactly how borrower behavior will be impacted by these economic conditions as the effectiveness of vaccinations, government stimulus and policy measures, customer relief and enhanced unemployment benefits have helped mitigate in the short term, but the extent and duration of government stimulus remains uncertain.

One of the most significant judgments involved in estimating our allowance for credit losses relates to the macroeconomic forecasts used to estimate credit losses over the reasonable and supportable forecast period. To determine the allowance for credit losses as of September 30, 2021, we utilized a single macroeconomic alternative baseline, or S7, scenario published by Moody's Analytics in September 2021.

During our previous quarterly macroeconomic assessment as of June 30, 2021, we also utilized the single S7 scenario published by Moody's Analytics. The economic scenario selected as of September 30, 2021 was based on our evaluation of the Moody's baseline economic forecast compared to other industry surveys over the reasonable and supportable period and our assessment of the reasonableness of impacts associated with the key monetary and government stimulus policy assumptions.

The following table summarizes the U.S. Real Gross Domestic Product (“GDP”) growth rates and unemployment rate assumptions used in our economic forecast to determine our best estimate of expected credit losses.

		As of				
		September 30, 2021	June 30, 2021	March 31, 2021	December 31, 2020	September 30, 2020
GDP growth rates:						
	Q3 2020					26.6%
	Q4 2020				4.0%	2.9%
	Q1 2021			5.0%	1.6%	3.6%
	Q2 2021		10.8%	6.5%	4.5%	3.1%
	Q3 2021	5.0%	6.6%	6.7%	4.7%	4.4%
	Q4 2021	7.5%	6.9%	4.8%	5.8%	6.0%
	Q1 2022	4.6%	5.4%	3.2%	4.8%	5.5%
	Q2 2022	2.8%	2.8%	2.5%	4.4%	
	Q3 2022	1.3%	2.3%	2.1%		
	Q4 2022	1.5%	1.8%			
	Q1 2023	2.4%				
Unemployment rates:						
	Q3 2020					8.9%
	Q4 2020				6.7%	9.1%
	Q1 2021			6.3%	6.9%	8.9%
	Q2 2021		5.8%	6.2%	7.1%	8.7%
	Q3 2021	5.2%	5.2%	5.8%	7.0%	8.3%
	Q4 2021	4.5%	4.5%	5.4%	6.8%	7.8%
	Q1 2022	3.9%	4.0%	5.1%	6.5%	7.3%
	Q2 2022	3.5%	3.7%	4.9%	6.2%	
	Q3 2022	3.4%	3.6%	4.7%		
	Q4 2022	3.3%	3.5%			
	Q1 2023	3.3%				

As of September 30, 2021, our economic forecast improved from June 30, 2021, as unemployment rates improve faster than the prior quarter’s outlook to below 3% by the end of 2023 and commercial real estate prices nationally have returned to pre-COVID 19 levels this quarter. Real GDP growth rates were revised lower based on updated economic data and consider potential supply-chain impacts on business and consumer spending. Our economic forecast continues to consider additional risks to U.S. economic recovery from recent inflation rates observed higher than Moody’s baseline scenario. We assume the Federal Reserve continues to support a target range of the federal funds rate near 0% through monetary policy support until the fourth quarter of 2022 when interest rates begin to increase.

As of December 31, 2020, our near-term economic forecast improved from September 30, 2020, reflecting better than expected economic data and approval of additional government stimulus earlier than expected. As such, projected real GDP growth in the first quarter of 2021 was revised upward. However, we revised our near-term 2021 real GDP forecast to reflect approximately \$900 billion of additional stimulus compared to \$1.5 trillion planned as of September 30, 2020. Unemployment rate forecasts were adjusted lower based on economic data observed in October and November 2020, as well as recent COVID-19 vaccine approvals showing progress towards the next phase of labor market recovery. Forecasts for commercial real estate prices nationally were updated lower as of December 31, 2020 to reflect declines through 2022 and recovery to pre-COVID-19 levels in late 2024. Prior quarter forecasts as of September 30, 2020 assumed declines through 2021 and recovery to pre-COVID-19 levels in mid-2023. Our interest rate expectations continued to assume monetary policy support from the Federal Reserve and a target range of the federal funds rate at 0% to 0.25% into late 2023.

Since December 31, 2019, our economic forecast changed significantly year-over-year in response to weak economic conditions caused by the COVID-19 pandemic as developments occurred rapidly in February and March 2020 associated with fiscal and monetary stimulus measures and the expected beneficial impacts of the CARES Act and certain regulatory interagency guidance. As of December 31, 2019, we assumed the U.S. economy was in the late stages of the economic cycle with unemployment rates near historical lows of 3.6% increasing to 3.8% in the fourth quarter of 2020 and reverting to historical data in the fourth quarter of 2022. Downside risks to the economy were concerns over international trade war between the U.S. and its trading partners and potential fallout from a Brexit in 2020. Interest rate expectations assumed one rate cut in 2020 with the Federal Reserve target range of the federal funds rate at 1.25% to 1.50% before reverting to historical data in 2023. In response to the COVID-19 pandemic, the Federal Reserve twice cut

federal funds rate targets in March 2020 to 0% to 0.25% with interest rate expectations as of December 31, 2020 unchanged until late 2023. Several U.S. fiscal and monetary policy changes during early 2020 were enacted to counter a severe, but short U.S. recession during the first half of 2020 and support a strong economic recovery during the second half of 2020 with U.S. budget deficits increasing to more than \$3 trillion during the year. U.S. unemployment rates reached 14.8% in April 2020 before declining to 6.7% as of December 31, 2020, which was 3.1% higher than the unemployment rate as of December 31, 2019. Annualized real GDP growth rates declined 31.4% in the second quarter of 2020 and increased 33.4% in the third quarter of 2020. The U.S. presidential election later in 2020 resulted in several changes, as Presidential Candidate Joe Biden won the electoral vote to replace President Donald Trump in 2021 and majority control of the U.S. Congress moved from Republican to Democratic parties. As economic growth slowed during the fourth quarter of 2020, additional government stimulus of approximately \$900 billion was approved.

As previously discussed, we adopted the new CECL standard and recorded transition adjustment entries that resulted in an allowance for credit losses for loans held for investment of \$73.7 million as of January 1, 2020, an increase of \$12.6 million. This increase reflected credit losses of \$18.9 million from the expansion of the loss horizon to life of loan and also takes into account forecasts of expected future macroeconomic conditions, partially offset by the elimination of the non-credit component within the historical allowance related to previously categorized PCI loans of \$6.3 million. This increase, net of tax, was largely reflected within the banking segment and included a decrease of \$5.7 million to opening retained earnings at January 1, 2020.

During the three and nine months ended September 30, 2021, the decreases in the allowance for credit losses reflect improvement in both realized economic results and the macroeconomic outlook and were significantly comprised of net reversals of credit losses on expected losses of collectively evaluated loans of \$11.0 million and \$45.2 million, respectively. Such reversals were primarily due to improvements in both macroeconomic forecast assumptions and credit quality metrics on COVID-19 impacted industry sector exposures. The net impact to the allowance of changes associated with individually evaluated loans during the three and nine months ended September 30, 2021 included a provision for credit losses of \$5.2 million and \$5.6 million, respectively. The changes in the allowance for credit losses during the noted periods were primarily attributable to the Bank and also reflected other factors including, but not limited to, loan mix, and changes in loan balances and qualitative factors from the prior quarter. The changes in the allowance during both the three and nine months ended September 30, 2021 were also impacted by net recoveries of \$0.1 million.

As discussed under the section titled “Loan Portfolio” earlier in this Item 2, the Bank’s actions beginning in the second and third quarters of 2020 included supporting our impacted banking clients experiencing an increased level of risk due to the COVID-19 pandemic through loan modifications. This deteriorating economic outlook resulted in a significant build in the allowance and included provision for credit losses through the second quarter of 2020. Beginning in the fourth quarter of 2020, improvement in both economic results and the macroeconomic outlook, coupled with government stimulus and positive risk rating grade migration within the Bank, have resulted in aggregate reversals of a significant portion of previously recorded credit losses. As a result, the allowance for credit losses as a percentage of our total loan portfolio, excluding margin loans in the broker-dealer segment and banking segment mortgage warehouse lending and PPP lending programs, was 1.74% as of September 30, 2021, down from a high of 2.63% as of September 30, 2020.

The respective distribution of the allowance for credit losses as a percentage of our total loan portfolio and total active loan modifications, excluding margin loans in the broker-dealer segment and banking segment mortgage warehouse lending and PPP lending programs, are presented in the following table (dollars in thousands).

<u>September 30, 2021</u>	<u>Total Loans Held For Investment</u>	<u>Total Allowance for Credit Losses</u>	<u>Allowance For Credit Losses as a % of Total Loans Held For Investment</u>	<u>Active Loan Modifications</u>	<u>Allowance For Credit Losses on Active Loan Modifications</u>	<u>Allowance For Credit Losses as a % of Active Loan Modifications</u>
Commercial real estate	\$ 3,032,141	\$ 68,535	2.26 %	\$ 8,966	\$ 3,138	35.00 %
Commercial and industrial ⁽¹⁾	1,311,598	30,292	2.31 %	3,816	692	18.13 %
Construction and land development	789,693	5,100	0.65 %	—	—	— %
1-4 family residential	1,104,847	4,538	0.41 %	4,310	75	1.74 %
Consumer	29,547	504	1.71 %	—	—	— %
	<u>6,267,826</u>	<u>108,969</u>	1.74 %	<u>17,092</u>	<u>3,905</u>	22.85 %
Broker-dealer	645,901	290	0.04 %	—	—	— %
Mortgage warehouse lending	505,976	253	0.05 %	—	—	— %
Paycheck Protection Program	133,223	—	— %	—	—	— %
	<u>\$ 7,552,926</u>	<u>\$ 109,512</u>	1.45 %	<u>\$ 17,092</u>	<u>\$ 3,905</u>	22.85 %

(1) Commercial and industrial portfolio amounts reflect balances excluding banking segment mortgage warehouse lending and PPP loans.

Allowance Model Sensitivity

Our allowance model was designed to capture the historical relationship between economic and portfolio changes. As such, evaluating shifts in individual portfolio attributes or macroeconomic variables in isolation may not be indicative of past or future performance. It is difficult to estimate how potential changes in any one factor or input might affect the overall allowance for credit losses because we consider a wide variety of factors and inputs in the allowance for credit losses estimate. Changes in the factors and inputs considered may not occur at the same rate and may not be consistent across all geographies or product types, and changes in factors and input may be directionally inconsistent, such that improvement in one factor may offset deterioration in others.

However, to consider the sensitivity of credit loss estimates to alternative macroeconomic forecasts, we compared the Company's allowance for credit loss estimates as of September 30, 2021, excluding margin loans in the broker-dealer segment, the banking segment mortgage warehouse and PPP lending programs, with modeled results using both upside ("S1") and downside ("S3") economic scenario forecasts published by Moody's Analytics.

Compared to our economic forecast, the upside scenario assumes consumer and business confidence increases as new cases, hospitalizations and deaths from COVID-19 recede faster than expected, while availability and acceptance of vaccines and consumer spending accelerate more than expected. Real GDP is expected to grow 11.0% in the fourth quarter of 2021, 7.3% in the first quarter of 2022, and 4.2% in the second quarter of 2022. Average unemployment rates decline to 4.3% by the fourth quarter of 2021 and 2.9% by the end of 2022. Monetary and fiscal policy assumptions include the Federal Reserve maintaining a near 0% target for the federal funds rate until the beginning of 2023 and additional government infrastructure and social program spending approved in the fourth quarter of 2021 of \$2.5 trillion.

Compared to our economic forecast, the downside scenario assumes consumer and business confidence declines as new cases, hospitalizations and deaths from COVID-19 diminish more slowly than expected, resulting in fewer people than expected getting vaccinated and increased worries about resistant strains. As a result, consumer confidence and spending erode causing the economy to fall back into recession. Real GDP is expected to decrease 3.5% in the fourth quarter of 2021, 3.3% in the first quarter of 2022, and 2.2% in the second quarter of 2022. Average unemployment rates increase to 6.7% by the fourth quarter of 2021 and 9.1% by the end of 2022. Average unemployment is expected to remain elevated but improve to 6.8% by the fourth quarter of 2023 and reverts to historical average rates over time. Monetary and fiscal policy assumptions include the Federal Reserve maintaining a near 0% target for the federal funds rate through late-2025, while disagreements in Congress prevent any additional stimulus from being enacted beyond the American Rescue Plan Act passed in March 2021.

The impact of applying all of the assumptions of the upside economic scenario during the reasonable and supportable forecast period would have resulted in a decrease in the allowance for credit losses of approximately \$10 million or a weighted average expected loss rate of 1.3% as a percentage of our total loan portfolio, excluding margin loans in the broker-dealer segment and the banking segment mortgage warehouse lending and PPP lending programs.

The impact of applying all of the assumptions of the downside economic scenario during the reasonable and supportable forecast period would have resulted in an increase in the allowance for credit losses of approximately \$48 million or a weighted average expected loss rate of 2.2% as a percentage of our total loan portfolio, excluding margin loans in the broker-dealer segment and the banking segment mortgage warehouse lending and PPP lending programs.

This analysis relates only to the modeled credit loss estimates and is not intended to estimate changes in the overall allowance for credit losses as they do not reflect any potential changes in the adjustment to the quantitative calculation, which would also be influenced by the judgment management applies to the modeled lifetime loss estimates to reflect the uncertainty and imprecision of these modeled lifetime loss estimates based on then-current circumstances and conditions. It also did not consider impacts from recent Bank deferral and customer accommodation efforts or government fiscal and monetary stimulus measures.

Our allowance for credit losses reflects our best estimate of current expected credit losses, which is highly dependent on the path of the virus. We continue to monitor the impact of the COVID-19 pandemic and related policy measures on the economy and if pace and vigor of the expected recovery is worse than expected, further meaningful provisions could be required. Future allowance for credit losses may vary considerably for these reasons.

Allowance Activity

The following table presents the activity in our allowance for credit losses within our loan portfolio for the periods presented (in thousands). Substantially all of the activity shown below occurred within the banking segment.

<u>Loans Held for Investment</u>	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2021</u>	<u>2020</u>	<u>2021</u>	<u>2020</u>
Balance, beginning of period	\$ 115,269	\$ 156,383	\$ 149,044	\$ 61,136
Transition adjustment for adoption of CECL accounting standard	—	—	—	12,562
Provision for (reversal of) credit losses	(5,819)	(602)	(39,648)	99,973
Recoveries of loans previously charged off:				
Commercial real estate	19	571	253	592
Commercial and industrial	598	382	1,732	1,450
Construction and land development	—	—	—	2
1-4 family residential	20	10	482	25
Consumer	26	84	171	308
Broker-dealer	—	—	—	—
Total recoveries	<u>663</u>	<u>1,047</u>	<u>2,638</u>	<u>2,377</u>
Loans charged off:				
Commercial real estate	124	29	310	4,517
Commercial and industrial	317	1,341	1,738	15,325
Construction and land development	—	—	—	2
1-4 family residential	87	144	248	517
Consumer	73	100	226	473
Broker-dealer	—	—	—	—
Total charge-offs	<u>601</u>	<u>1,614</u>	<u>2,522</u>	<u>20,834</u>
Net recoveries (charge-offs)	<u>62</u>	<u>(567)</u>	<u>116</u>	<u>(18,457)</u>
Balance, end of period	<u>\$ 109,512</u>	<u>\$ 155,214</u>	<u>\$ 109,512</u>	<u>\$ 155,214</u>
Allowance for credit losses as a percentage of gross loans held for investment			<u>1.45 %</u>	<u>1.95 %</u>

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

	September 30, 2021		December 31, 2020	
	Reserve	% of Gross Loans	Reserve	% of Gross Loans
Commercial real estate	\$ 68,535	40.15 %	\$ 109,629	40.74 %
Commercial and industrial	30,545	25.84 %	27,703	34.16 %
Construction and land development.	5,100	10.45 %	6,677	10.77 %
1-4 family residential	4,538	14.63 %	3,946	8.19 %
Consumer.	504	0.39 %	876	0.46 %
Broker-dealer.	290	8.54 %	213	5.68 %
Total	<u>\$ 109,512</u>	<u>100.00 %</u>	<u>\$ 149,044</u>	<u>100.00 %</u>

The following table summarizes historical levels of the allowance for credit losses on loans held for investment, distributed by portfolio segment (in thousands).

	September 30, 2021	June 30, 2021	March 31, 2021	December 31, 2020	September 30, 2020
Commercial real estate	\$ 68,535	\$ 77,633	\$ 104,126	\$ 109,629	\$ 104,566
Commercial and industrial	30,545	27,866	28,513	27,703	38,178
Construction and land development.	5,100	5,185	7,249	6,677	6,270
1-4 family residential	4,538	3,659	3,388	3,946	5,052
Consumer.	504	592	944	876	1,002
Broker-dealer.	290	334	279	213	146
	<u>\$ 109,512</u>	<u>\$ 115,269</u>	<u>\$ 144,499</u>	<u>\$ 149,044</u>	<u>\$ 155,214</u>

Unfunded Loan Commitments

In order to estimate the allowance for credit losses on unfunded loan commitments, the Bank uses a process similar to that used in estimating the allowance for credit losses on the funded portion. The allowance is based on the estimated exposure at default, multiplied by the lifetime probability of default grade and loss given default grade for that particular loan segment. The Bank estimates expected losses by calculating a commitment usage factor based on industry usage factors. The commitment usage factor is applied over the relevant contractual period. Loss factors from the underlying loans to which commitments are related are applied to the results of the usage calculation to estimate any liability for credit losses related for each loan type. The expected losses on unfunded commitments align with statistically calculated parameters used to calculate the allowance for credit losses on the funded portion. Letters of credit are not currently reserved because they are issued primarily as credit enhancements and the likelihood of funding is low.

Changes in the allowance for credit losses for loans with off-balance sheet credit exposures are shown below (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2021	2020	2021	2020
Balance, beginning of period.	\$ 7,981	\$ 9,031	\$ 8,388	\$ 2,075
Transition adjustment CECL accounting standard . . .	—	—	—	3,837
Other noninterest expense	(1,183)	287	(1,590)	3,406
Balance, end of period.	<u>\$ 6,798</u>	<u>\$ 9,318</u>	<u>\$ 6,798</u>	<u>\$ 9,318</u>

As previously discussed, we adopted the new CECL standard and recorded a transition adjustment entry that resulted in an allowance for credit losses of \$5.9 million as of January 1, 2020. During the three and nine months ended September 30, 2021, the decrease in the reserve for unfunded commitments was primarily due to improvements in loan expected loss rates.

Potential Problem Loans

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which management has concerns about the ability of an obligor to continue to comply with repayment terms because of the obligor's potential operating or financial difficulties. Management monitors these loans and reviews their performance

on a regular basis. Potential problem loans contain potential weaknesses that could improve, persist or further deteriorate. If such potential weaknesses persist without improving, the loan is subject to downgrade, typically to substandard, in three to six months. Potential problem loans are assigned a grade of special mention within our risk grading matrix. Potential problem loans do not include purchased credit deteriorated (“PCD”) loans because PCD loans exhibited evidence of more than insignificant credit deterioration at acquisition that made it probable that all contractually required principal payments would not be collected. Additionally, potential problem loans do not include loans that have been modified in connection with our COVID-19 payment deferment programs which allow for a deferral of principal and/or interest payments. Within our loan portfolio, we had three credit relationships totaling \$9.9 million of potential problem loans at September 30, 2021, compared with seven credit relationships totaling \$11.3 million of potential problem loans at December 31, 2020.

Non-Performing Assets

In response to the COVID-19 pandemic, the CARES Act was passed in March 2020, which among other things, allows the Bank to suspend the TDR requirements for certain loan modifications to be categorized as a TDR. Starting in March 2020, the Bank implemented several actions to better support our impacted banking clients and allow for loan modifications such as principal and/or interest payment deferrals, participation in the PPP as an SBA preferred lender and personal banking assistance including waived fees, increased daily spending limits and suspension of residential foreclosure activities. The COVID-19 payment deferment programs allow for a deferral of principal and/or interest payments with such deferred principal payments due and payable on the maturity date of the existing loan.

Specifically, as discussed under the section titled “Loan Portfolio” earlier in this Item 2, the Bank’s actions during 2020 included approval of \$1.0 billion of COVID-19 related loan modifications. During 2021, the Bank continued to support its impacted banking clients through the approval of COVID-19 related loan modifications with a portfolio of active deferrals that have not reached the end of their deferral period of approximately \$17 million as of September 30, 2021. While the majority of the portfolio of COVID-19 related loan modifications no longer require deferral, such loans represent elevated risk, and therefore management continues to monitor these loans. The extent to which these measures will impact the Bank, and any progression of loans, whether receiving COVID-19 payment deferrals or not, into non-performing assets, during future periods is uncertain and will depend on future developments that cannot be predicted.

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

	<u>September 30, 2021</u>	<u>December 31, 2020</u>	<u>Variance</u>
Loans accounted for on a non-accrual basis:			
Commercial real estate	\$ 5,705	\$ 11,133	\$ (5,428)
Commercial and industrial	29,808	34,049	(4,241)
Construction and land development	366	507	(141)
1-4 family residential	25,255	32,263	(7,008)
Consumer	24	28	(4)
Broker-dealer	—	—	—
	<u>\$ 61,158</u>	<u>\$ 77,980</u>	<u>\$ (16,822)</u>
Troubled debt restructurings included in accruing loans held for investment	1,038	1,954	(916)
Non-performing loans	<u>\$ 62,196</u>	<u>\$ 79,934</u>	<u>\$ (17,738)</u>
Non-performing loans as a percentage of total loans	<u>0.64 %</u>	<u>0.76 %</u>	<u>(0.12)%</u>
Other real estate owned	<u>\$ 21,605</u>	<u>\$ 21,289</u>	<u>\$ 316</u>
Other repossessed assets	<u>\$ —</u>	<u>\$ 101</u>	<u>\$ (101)</u>
Non-performing assets	<u>\$ 83,801</u>	<u>\$ 101,324</u>	<u>\$ (17,523)</u>
Non-performing assets as a percentage of total assets	<u>0.47 %</u>	<u>0.60 %</u>	<u>(0.13)%</u>
Loans past due 90 days or more and still accruing	<u>\$ 175,734</u>	<u>\$ 243,630</u>	<u>\$ (67,896)</u>

At September 30, 2021, non-accrual loans included 46 commercial and industrial relationships with loans secured by accounts receivable, life insurance, oil and gas, livestock and equipment. Non-accrual loans at September 30, 2021 also included \$5.3 million of loans secured by residential real estate which were classified as loans held for sale. At December 31, 2020, non-accrual loans included 60 commercial and industrial relationships with loans secured by accounts receivable, life insurance, oil and gas, livestock and equipment. Non-accrual loans at December 31, 2020 also included \$10.9 million of loans secured by residential real estate which were classified as loans held for sale.

At September 30, 2021, TDRs were comprised of \$1.0 million of loans that are considered to be performing and accruing, and \$13.2 million of loans considered to be non-performing reported in non-accrual loans. At December 31, 2020, TDRs were comprised of \$2.0 million of loans that are considered to be performing and accruing, and \$16.0 million of loans that were considered to be non-performing reported in non-accrual loans. In March 2020, the CARES Act was passed, which, among other things, allows the Bank to suspend the requirements for certain loan modifications to be categorized as a TDR. Therefore, the Bank is not reporting COVID-19 related modifications as TDRs in accordance with the CARES Act.

OREO increased from December 31, 2020 to September 30, 2021, primarily due additions of \$2.9 million, partially offset by disposals and valuation adjustments totaling \$2.6 million. At both September 30, 2021 and December 31, 2020, OREO was primarily comprised of commercial properties.

Loans past due 90 days or more and still accruing at September 30, 2021 and December 31, 2020, were primarily comprised of loans held for sale and guaranteed by U.S. government agencies, including GNMA-related loans subject to repurchase within our mortgage origination segment. As of September 30, 2021, \$99.9 million of loans subject to repurchase were under a forbearance agreement resulting from the COVID-19 pandemic. During May 2020, GNMA announced it will temporarily exclude any new GNMA lender delinquencies, occurring on or after April 2020, when calculating the delinquency ratios for the purposes of enforcing compliance with its delinquency rate thresholds. This exclusion is extended automatically to GNMA lenders that were compliant with GNMA's delinquency rate thresholds as reflected by their April 2020 investor accounting report. The mortgage origination segment qualified for this exclusion as of September 30, 2021. As of September 30, 2021, \$99.5 million of loans subject to repurchase under a forbearance agreement had delinquencies on or after April 2020.

Deposits

The banking segment's major source of funds and liquidity is its deposit base. Deposits provide funding for its investments in loans and securities. Interest paid for deposits must be managed carefully to control the level of interest expense and overall net interest margin. The composition of the deposit base (time deposits versus interest-bearing demand deposits and savings), as discussed in more detail within the section titled "Liquidity and Capital Resources — Banking Segment" below, is constantly changing due to the banking segment's needs and market conditions.

The table below presents the average balance of, and rate paid on, consolidated deposits (dollars in thousands).

	Nine Months Ended September 30,			
	2021		2020	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
Noninterest-bearing demand deposits	\$ 4,040,649	0.00 %	\$ 3,182,002	0.00 %
Interest-bearing demand deposits	5,921,329	0.31 %	5,263,228	0.42 %
Savings deposits	287,282	0.10 %	221,429	0.10 %
Time deposits	1,454,340	1.40 %	1,869,877	1.50 %
	<u>\$ 11,703,600</u>	0.34 %	<u>\$ 10,536,536</u>	0.48 %

Borrowings

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

	September 30, 2021		December 31, 2020		Variance
	Balance	Average Rate Paid	Balance	Average Rate Paid	
Short-term borrowings	\$ 747,040	1.28 %	\$ 695,798	1.46 %	\$ 51,242
Notes payable	395,804	5.66 %	381,987	4.54 %	13,817
Junior subordinated debentures	—	2.74 %	67,012	4.13 %	(67,012)
	<u>\$ 1,142,844</u>	<u>1.83 %</u>	<u>\$ 1,144,797</u>	<u>2.51 %</u>	<u>\$ (1,953)</u>

Short-term borrowings consisted of federal funds purchased, securities sold under agreements to repurchase, borrowings at the Federal Home Loan Bank (“FHLB”), short-term bank loans and commercial paper. The increase in short-term borrowings at September 30, 2021, compared with December 31, 2020, primarily included increases in short-term bank loans and commercial paper used by the Hilltop Broker-Dealers to finance their activities, partially offset by a decrease in securities sold under agreements to repurchase by the Hilltop Broker-Dealers. Notes payable at September 30, 2021 was comprised of \$149.1 million related to the Senior Notes, net of loan origination fees, Subordinated Notes, net of origination fees, of \$197.0 million and mortgage origination segment borrowings of \$49.7 million. As discussed in more detail within the section titled “Liquidity and Capital Resources — Junior Subordinated Debentures” below, during the third quarter of 2021, PCC fully redeemed all outstanding Debentures.

Liquidity and Capital Resources

Hilltop is a financial holding company whose assets primarily consist of the stock of its subsidiaries and invested assets. Hilltop’s primary investment objectives, as a holding company, are to support capital deployment for organic growth and to preserve capital to be deployed through acquisitions, dividend payments and stock repurchases. At September 30, 2021, Hilltop had \$343.1 million in cash and cash equivalents, a decrease of \$31.7 million from \$374.8 million at December 31, 2020. This decrease in cash and cash equivalents was primarily due to \$29.5 million in cash dividends declared, \$123.6 million of stock repurchases, and other general corporate expenses, partially offset by the receipt of \$217.5 million of dividends from subsidiaries. Subject to regulatory restrictions, Hilltop has received, and may also continue to receive, dividends from its subsidiaries. If necessary or appropriate, we may also finance acquisitions with the proceeds from equity or debt issuances. We believe that Hilltop’s liquidity is sufficient for the foreseeable future, with current short-term liquidity needs including operating expenses, interest on debt obligations, dividend payments to stockholders and potential stock repurchases.

COVID-19

As previously discussed, in light of the extreme volatility and disruptions in the capital and credit markets beginning in March 2020 resulting from the COVID-19 crisis and its negative impact on the economy, we took a number of precautionary actions beginning in March 2020 to enhance our financial flexibility, protect capital, minimize losses and ensure target liquidity levels.

To strengthen the Bank’s available liquidity position during 2020, we raised brokered deposits, as well as swept additional deposits from Hilltop Securities into the Bank. At September 30, 2021, given the continued strong cash and liquidity levels at the Bank, brokered deposits declined to approximately \$243 million and the total funds swept from Hilltop Securities into the Bank was approximately \$800 million. In addition, we continue to evaluate market conditions to determine the appropriateness of capital market inventory limits at Hilltop Securities.

To meet demand for customer loan advances and satisfy our obligations to repay any debt maturing over the next 12 months, we believe we currently have sufficient liquidity from the available on- and off-balance sheet liquidity sources and our ability to issue debt in the capital markets. We continue to review actions that we may take to further enhance our financial flexibility in the event that market conditions deteriorate for an extended period.

Dividend Declaration

On October 28, 2021, our board of directors declared a quarterly cash dividend of \$0.12 per common share, payable on November 30, 2021 to all common stockholders of record as of the close of business on November 15, 2021.

Future dividends on our common stock are subject to the determination by the board of directors based on an evaluation of our earnings and financial condition, liquidity and capital resources, the general economic and regulatory climate, our ability to service any equity or debt obligations senior to our common stock and other factors.

Stock Repurchases

In January 2021, our board of directors authorized a new stock repurchase program through January 2022 pursuant to which we were originally authorized to repurchase, in the aggregate, up to \$75.0 million of our outstanding common stock. In July 2021, our board of directors authorized an increase to the aggregate amount of common stock we may repurchase under this program by \$75.0 million to \$150.0 million. Then, in October 2021, our board of directors authorized, subject to regulatory review, an increase to the aggregate amount of common stock we may repurchase under this program by \$50.0 million to \$200.0 million, which is inclusive of repurchases to offset dilution related to grants of stock-based compensation. Under the stock repurchase program authorized, we may repurchase shares in the open market or through privately negotiated transactions as permitted under Rule 10b-18 promulgated under the Exchange Act. The extent to which we repurchase our shares and the timing of such repurchases depends upon market conditions and other corporate considerations, as determined by Hilltop's management team. Repurchased shares will be returned to our pool of authorized but unissued shares of common stock.

During the nine months ended September 30, 2021, we paid \$123.6 million to repurchase an aggregate of 3,632,482 shares of common stock at a weighted average price of \$34.01 per share. The purchases were funded from available cash balances.

Senior Notes due 2025

The Senior Notes bear interest at a rate of 5% per year, payable semi-annually in arrears in cash on April 15 and October 15 of each year, commencing on October 15, 2015. The Senior Notes will mature on April 15, 2025, unless we redeem the Senior Notes, in whole at any time or in part from time to time, on or after January 15, 2025 (three months prior to the maturity date of the Senior Notes) at our election at a redemption price equal to 100% of the principal amount of the Senior Notes to be redeemed plus accrued and unpaid interest to, but excluding, the redemption date. At September 30, 2021, \$150.0 million of our Senior Notes was outstanding.

Subordinated Notes due 2030 and 2035

On May 7, 2020, we completed a public offering of \$50 million aggregate principal amount of 2030 Subordinated Notes and \$150 million aggregate principal amount of 2035 Subordinated Notes. The price to the public for the Subordinated Notes was 100% of the principal amount of the Subordinated Notes. The net proceeds from the offering, after deducting underwriting discounts and fees and expenses of \$3.4 million, were \$196.6 million.

The 2030 Subordinated Notes and the 2035 Subordinated Notes will mature on May 15, 2030 and May 15, 2035, respectively. We may redeem the Subordinated Notes, in whole or in part, from time to time, subject to obtaining Federal Reserve approval, beginning with the interest payment date of May 15, 2025 for the 2030 Subordinated Notes and beginning with the interest payment date of May 15, 2030 for the 2035 Subordinated Notes at a redemption price equal to 100% of the principal amount of the Subordinated Notes being redeemed plus accrued and unpaid interest to but excluding, the date of redemption.

The 2030 Subordinated Notes bear interest at a rate of 5.75% per year, payable semi-annually in arrears commencing on November 15, 2020. The interest rate for the 2030 Subordinated Notes will reset quarterly beginning May 15, 2025 to an interest rate, per year, equal to the then-current benchmark rate, which is expected to be three-month term SOFR rate, plus 5.68%, payable quarterly in arrears. The 2035 Subordinated Notes bear interest at a rate of 6.125% per year, payable semi-annually in arrears commencing on November 15, 2020. The interest rate for the 2035 Subordinated Notes will reset quarterly beginning May 15, 2030 to an interest rate, per year, equal to the then-current benchmark rate, which is expected to be three-month term SOFR rate plus 5.80%, payable quarterly in arrears. At September 30, 2021, \$200.0 million of our Subordinated Notes was outstanding.

Junior Subordinated Debentures

Following receipt of regulatory approval, in June 2021, PCC submitted to the trustee of one of the statutory trusts a notice to redeem in full outstanding Debentures in the principal amount of \$18.0 million on July 31, 2021 (which resulted in the full redemption to the holders of the associated preferred securities and common securities).

Subsequently, during July and August 2021, PCC submitted to the trustees of each of the three remaining statutory trusts a notice to redeem in full outstanding Debentures in the aggregate principal amount of \$49.0 million during September 2021 (which resulted in the full redemption to the holders of the associated preferred securities and common securities).

The Debentures, which were held by four statutory trusts created for the sole purpose of issuing and selling preferred securities and common securities used to acquire the Debentures, had an original stated term of 30 years with original maturities ranging from July 2031 to February 2038. The Debentures were callable at PCC's discretion with a minimum of a 45- to 60- day notice. At September 30, 2021, PCC had no remaining borrowings associated with the Debentures. The redemptions noted above were funded from available cash balances held at PCC.

Regulatory Capital

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements may prompt certain actions by regulators that, if undertaken, could have a direct material adverse effect on our financial condition and results of operations. Under capital adequacy and regulatory requirements, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

In order to avoid limitations on capital distributions, including dividend payments, stock repurchases and certain discretionary bonus payments to executive officers, Basel III requires banking organizations to maintain a capital conservation buffer above minimum risk-based capital requirements measured relative to risk-weighted assets.

The following table shows PlainsCapital's and Hilltop's actual capital amounts and ratios in accordance with Basel III compared to the regulatory minimum capital requirements including conservation buffer ratio in effect at September 30, 2021 (dollars in thousands). Based on actual capital amounts and ratios shown in the following table, PlainsCapital's ratios place it in the "well capitalized" (as defined) capital category under regulatory requirements. Actual capital amounts and ratios as of September 30, 2021 reflect PlainsCapital's and Hilltop's decision to elect the transition option as issued by the federal banking regulatory agencies in March 2020 that permits banking institutions to mitigate the estimated cumulative regulatory capital effects from CECL over a five-year transitional period.

	<u>September 30, 2021</u>		Minimum Capital Requirements Including Conservation Buffer	To Be Well Capitalized
	<u>Amount</u>	<u>Ratio</u>	<u>Ratio</u>	<u>Ratio</u>
Tier 1 capital (to average assets):				
PlainsCapital	\$ 1,398,761	10.02 %	4.0 %	5.0 %
Hilltop.	2,209,309	12.64 %	4.0 %	N/A
Common equity Tier 1 capital (to risk-weighted assets):				
PlainsCapital	1,398,761	15.40 %	7.0 %	6.5 %
Hilltop.	2,209,309	21.28 %	7.0 %	N/A
Tier 1 capital (to risk-weighted assets):				
PlainsCapital	1,398,761	15.40 %	8.5 %	8.0 %
Hilltop.	2,209,309	21.28 %	8.5 %	N/A
Total capital (to risk-weighted assets):				
PlainsCapital	1,482,471	16.32 %	10.5 %	10.0 %
Hilltop.	2,492,353	24.00 %	10.5 %	N/A

We discuss regulatory capital requirements in more detail in Note 17 to our consolidated financial statements, as well as under the caption “Government Supervision and Regulation — Corporate — Capital Adequacy Requirements and BASEL III” set forth in Part I, Item I. of our 2020 Form 10-K.

Banking Segment

Within our banking segment, our primary uses of cash are for customer withdrawals and extensions of credit as well as our borrowing costs and other operating expenses. Our corporate treasury group is responsible for continuously monitoring our liquidity position to ensure that our assets and liabilities are managed in a manner that will meet our short-term and long-term cash requirements. Our goal is to manage our liquidity position in a manner such that we can meet our customers’ short-term and long-term deposit withdrawals and anticipated and unanticipated increases in loan demand without penalizing earnings. Funds invested in short-term marketable instruments, the continuous maturing of other interest-earning assets, cash flows from self-liquidating investments such as mortgage-backed securities and collateralized mortgage obligations, the possible sale of available for sale securities and the ability to securitize certain types of loans provide sources of liquidity from an asset perspective. The liability base provides sources of liquidity through deposits and the maturity structure of short-term borrowed funds. For short-term liquidity needs, we utilize federal fund lines of credit with correspondent banks, securities sold under agreements to repurchase, borrowings from the Federal Reserve and borrowings under lines of credit with other financial institutions. For intermediate liquidity needs, we utilize advances from the FHLB. To supply liquidity over the longer term, we have access to brokered time deposits, term loans at the FHLB and borrowings under lines of credit with other financial institutions.

As previously discussed, to meet increased liquidity demands and ensure availability of adequate cash to meet both expected and unexpected funding needs without adversely affecting our daily operations and to improve the Bank’s already strong liquidity position, we raised brokered deposits during 2020 that have a remaining balance of approximately \$243 million at September 30, 2021, down from approximately \$731 million at December 31, 2020. Further, beginning in March 2020, additional deposits were swept from Hilltop Securities into the Bank. Since June 30, 2020, given the continued strong cash and liquidity levels at the Bank, the total funds swept from Hilltop Securities into the Bank was reduced, and is approximately \$800 million as of September 30, 2021. As a result, the Bank was able to further fortify its borrowing capacity through access to secured funding sources as summarized in the following table (in millions).

	September 30, 2021	December 31, 2020
FHLB capacity	\$ 4,411	\$ 4,410
Investment portfolio (available)	1,455	982
Fed deposits (excess daily requirements) . .	2,302	875
	<u>\$ 8,168</u>	<u>\$ 6,267</u>

As noted in the table above, the Bank’s available liquidity position and borrowing capacity at September 30, 2021 continues to be at a heightened level given the uncertain outlook for 2021 and into 2022 due to the COVID-19 pandemic. While the extent to which COVID-19 will impact the Bank remains uncertain, the Bank is targeting available liquidity of between approximately \$5 billion and \$6 billion during the remainder of 2021. Available liquidity does not include borrowing capacity available through the discount window at the Federal Reserve.

Within our banking segment, deposit flows are affected by the level of market interest rates, the interest rates and products offered by competitors, the volatility of equity markets and other factors. While the Bank began to experience an increase in non-brokered customer deposits during 2020, an economic recovery and improved commercial real estate investment outlook may result in an outflow of deposits at an accelerated pace as customers utilize such available funds for expanded operations and investment opportunities. The Bank regularly evaluates its deposit products and pricing structures relative to the market to maintain competitiveness over time.

The Bank’s 15 largest depositors, excluding Hilltop and Hilltop Securities, collectively accounted for 8.96% of the Bank’s total deposits, and the Bank’s five largest depositors, excluding Hilltop and Hilltop Securities, collectively accounted for 4.44% of the Bank’s total deposits at September 30, 2021. The loss of one or more of our largest Bank customers, or a significant decline in our deposit balances due to ordinary course fluctuations related to these customers’ businesses, could adversely affect our liquidity and might require us to raise deposit rates to attract new deposits, purchase federal funds or borrow funds on a short-term basis to replace such deposits.

Broker-Dealer Segment

The Hilltop Broker-Dealers rely on their equity capital, short-term bank borrowings, interest-bearing and noninterest-bearing client credit balances, correspondent deposits, securities lending arrangements, repurchase agreement financing, commercial paper issuances and other payables to finance their assets and operations, subject to their respective compliance with broker-dealer net capital and customer protection rules. At September 30, 2021, Hilltop Securities had credit arrangements with four unaffiliated banks, with maximum aggregate commitments of up to \$600.0 million. These credit arrangements are used to finance securities owned, securities held for correspondent accounts, receivables in customer margin accounts and underwriting activities. These credit arrangements are provided on an “as offered” basis and are not committed lines of credit. In addition, Hilltop Securities has committed revolving credit facilities with three unaffiliated banks, with aggregate availability of up to \$250.0 million. At September 30, 2021, Hilltop Securities had borrowed \$64.0 million under its credit arrangements and had no borrowings under its credit facilities.

Hilltop Securities uses the net proceeds (after deducting related issuance expenses) from the sale of two commercial paper programs for general corporate purposes, including working capital and the funding of a portion of its securities inventories. The commercial paper notes (“CP Notes”) may be issued with maturities of 14 days to 270 days from the date of issuance. The commercial paper notes (“CP Notes”) are issued under two separate programs, Series 2019-1 CP Notes and Series 2019-2 CP Notes, in maximum aggregate amounts of \$300 million and \$200 million, respectively. As of September 30, 2021, the weighted average maturity of the CP Notes was 159 days at a rate of 1.06% with a weighted average remaining life of 85 days. At September 30, 2021, the aggregate amount outstanding under these secured arrangements was \$367.9 million, which was collateralized by securities held for firm accounts valued at \$400.5 million.

Mortgage Origination Segment

PrimeLending funds the mortgage loans it originates through warehouse lines of credit maintained with the Bank, which have an aggregate commitment of \$3.3 billion, of which \$1.8 billion was drawn at September 30, 2021. PrimeLending sells substantially all mortgage loans it originates to various investors in the secondary market, historically with the majority with servicing released. As these mortgage loans are sold in the secondary market, PrimeLending pays down its warehouse line of credit with the Bank. In addition, PrimeLending has an available line of credit with an unaffiliated bank of up to \$1.0 million, of which no borrowings were drawn at September 30, 2021.

PrimeLending owns a 100% membership interest in PrimeLending Ventures Management, LLC (“Ventures Management”) which holds an ownership interest in and is the managing member of certain ABAs. At September 30, 2021, these ABAs had combined available lines of credit totaling \$145.0 million, \$55.0 million of which was with a single unaffiliated bank, and the remaining \$90.0 million of which was with the Bank. At September 30, 2021, Ventures Management had outstanding borrowings of \$69.4 million, \$19.7 million of which was with the Bank.

Impact of Inflation and Changing Prices

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

Off-Balance Sheet Arrangements; Commitments; Guarantees

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

Banking Segment

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

Standby letters of credit are written conditional commitments issued by us to guarantee the performance of a customer to a third-party. In the event the customer does not perform in accordance with the terms of the agreement with the third-party, we would be required to fund the commitment. The maximum potential amount of future payments we could be required to make is represented by the contractual amount of the commitment. If the commitment is funded, we would be entitled to seek recovery from the customer. Our policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those contained in loan agreements.

In the aggregate, the Bank had outstanding unused commitments to extend credit of \$2.1 billion at September 30, 2021 and outstanding financial and performance standby letters of credit of \$87.2 million at September 30, 2021.

Broker-Dealer

In the normal course of business, the Hilltop Broker-Dealers execute, settle and finance various securities transactions that may expose the Hilltop Broker-Dealers to off-balance sheet risk in the event that a customer or counterparty does not fulfill its contractual obligations. Examples of such transactions include the sale of securities not yet purchased by customers or for the account of the Hilltop Broker-Dealers, use of derivatives to support certain non-profit housing organization clients, clearing agreements between the Hilltop Broker-Dealers and various clearinghouses and broker-dealers, secured financing arrangements that involve pledged securities, and when-issued underwriting and purchase commitments.

Critical Accounting Estimates

Our accounting policies are fundamental to understanding our management's discussion and analysis of our results of operations and financial condition. We have identified certain significant accounting policies which involve a higher degree of judgment and complexity in making certain estimates and assumptions that affect amounts reported in our consolidated financial statements. The significant accounting policies which we believe to be the most critical in preparing our consolidated financial statements relate to allowance for credit losses, goodwill and identifiable intangible assets, mortgage loan indemnification liability, mortgage servicing rights asset and acquisition accounting. Since December 31, 2020, there have been no changes in critical accounting policies as further described under "Critical Accounting Policies and Estimates" and Note 1 to the Consolidated Financial Statements in our 2020 Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our assessment of market risk as of September 30, 2021 indicates there are no material changes in the quantitative and qualitative disclosures from those previously reported in our 2020 Form 10-K, except as discussed below.

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

Banking Segment

The banking segment is engaged primarily in the business of investing funds obtained from deposits and borrowings in interest-earning loans and investments, and our primary component of market risk is sensitivity to changes in interest rates. Consequently, our earnings depend to a significant extent on our net interest income, which is the difference between interest income on loans and investments and our interest expense on deposits and borrowings. To the extent

that our interest-bearing liabilities do not reprice or mature at the same time as our interest-bearing assets, we are subject to interest rate risk and corresponding fluctuations in net interest income.

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

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

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

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

	September 30, 2021					Total
	3 Months or Less	> 3 Months to 1 Year	> 1 Year to 3 Years	> 3 Years to 5 Years	> 5 Years	
Interest sensitive assets:						
Loans	\$ 5,115,096	\$ 1,211,230	\$ 1,512,246	\$ 634,419	\$ 262,270	\$ 8,735,261
Securities	237,536	257,390	570,740	409,557	765,752	2,240,975
Federal funds sold and securities purchased under agreements to resell	406	—	—	—	—	406
Other interest sensitive assets	2,315,438	—	—	—	29,497	2,344,935
Total interest sensitive assets	<u>7,668,476</u>	<u>1,468,620</u>	<u>2,082,986</u>	<u>1,043,976</u>	<u>1,057,519</u>	<u>13,321,577</u>
Interest sensitive liabilities:						
Interest bearing checking	\$ 6,062,553	\$ —	\$ —	\$ —	\$ —	\$ 6,062,553
Savings	306,755	—	—	—	—	306,755
Time deposits	464,458	529,474	114,714	32,152	3	1,140,801
Notes payable and other borrowings	161,367	186	582	734	2,789	165,658
Total interest sensitive liabilities	<u>6,995,133</u>	<u>529,660</u>	<u>115,296</u>	<u>32,886</u>	<u>2,792</u>	<u>7,675,767</u>
Interest sensitivity gap	<u>\$ 673,343</u>	<u>\$ 938,960</u>	<u>\$ 1,967,690</u>	<u>\$ 1,011,090</u>	<u>\$ 1,054,727</u>	<u>\$ 5,645,810</u>
Cumulative interest sensitivity gap	<u>\$ 673,343</u>	<u>\$ 1,612,303</u>	<u>\$ 3,579,993</u>	<u>\$ 4,591,083</u>	<u>\$ 5,645,810</u>	
Percentage of cumulative gap to total interest sensitive assets	5.05 %	12.10 %	26.87 %	34.46 %	42.38 %	

The positive GAP in the interest rate analysis indicates that banking segment net interest income would generally rise if rates increase. Because of inherent limitations in interest rate GAP analysis, the banking segment uses multiple interest rate risk measurement techniques. Simulation analysis is used to subject the current repricing conditions to rising and falling interest rates in increments and decrements of 50 to 100 basis points to determine the effect on net interest income changes for the next twelve months. The banking segment also measures the effects of changes in interest rates on economic value of equity by discounting projected cash flows of deposits and loans. Economic value changes in the investment portfolio are estimated by discounting future cash flows and using duration analysis. Investment security prepayments are estimated using current market information. We believe the simulation analysis presents a more accurate picture than the GAP analysis. Simulation analysis recognizes that deposit products may not react to changes in interest rates as quickly or with the same magnitude as earning assets contractually tied to a market rate index. The sensitivity to changes in market rates varies across deposit products. Also, unlike GAP analysis, simulation analysis takes into account the effect of embedded options in the securities and loan portfolios as well as any off-balance sheet derivatives.

The table below shows the estimated impact of a range of changes in interest rates on net interest income and on economic value of equity for the banking segment at September 30, 2021 (dollars in thousands).

Change in Interest Rates (basis points)	Changes in Net Interest Income		Changes in Economic Value of Equity	
	Amount	Percent	Amount	Percent
+300	\$ 121,570	34.34 %	\$ 580,478	32.17 %
+200	\$ 78,848	22.27 %	\$ 416,627	23.09 %
+100	\$ 37,526	10.60 %	\$ 228,998	12.69 %
-50	\$ (6,124)	(1.73)%	\$ (302,911)	(16.79)%

The projected changes in net interest income and economic value of equity to changes in interest rates at September 30, 2021 were in compliance with established internal policy guidelines. These projected changes are based on numerous assumptions of growth and changes in the mix of assets or liabilities.

Our portfolio includes loans that periodically reprice or mature prior to the end of an amortized term. Some of our variable-rate loans remain at applicable rate floors, which may delay and/or limit changes in interest income during a period of changing rates. If interest rates were to fall, the impact on our interest income would be limited by these rate floors. In addition, declining interest rates may negatively affect our cost of funds on deposits. The extent of this impact will ultimately be driven by the timing, magnitude and frequency of interest rate and yield curve movements, as well as changes in market conditions and timing of management strategies. If interest rates were to rise, yields on the portion of our portfolio that remain at applicable rate floors would rise more slowly than increases in market interest rates. 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.

Broker-Dealer Segment

Our broker-dealer segment is exposed to market risk primarily due to its role as a financial intermediary in customer transactions, which may include purchases and sales of securities, use of derivatives and securities lending activities, and in our trading activities, which are used to support sales, underwriting and other customer activities. We are subject to the risk of loss that may result from the potential change in value of a financial instrument as a result of fluctuations in interest rates, market prices, investor expectations and changes in credit ratings of the issuer.

Our broker-dealer segment is exposed to interest rate risk as a result of maintaining inventories of interest rate sensitive financial instruments and other interest-earning assets including customer and correspondent margin loans and receivables and securities borrowing activities. Our funding sources, which include customer and correspondent cash balances, bank borrowings, repurchase agreements and securities lending activities, also expose the broker-dealer to interest rate risk. Movement in short-term interest rates could reduce the positive spread between the broker-dealer segment's interest income and interest expense.

With respect to securities held, our interest rate risk is managed by setting and monitoring limits on the size and duration of positions and on the length of time securities can be held. Much of the interest rates on customer and correspondent

margin loans and receivables are indexed and can vary daily. Our funding sources are generally short term with interest rates that can vary daily.

The following table categorizes the broker-dealer segment's net trading securities which are subject to interest rate and market price risk (dollars in thousands).

	September 30, 2021				
	1 Year or Less	> 1 Year to 5 Years	> 5 Years to 10 Years	> 10 Years	Total
Trading securities, at fair value					
Municipal obligations	\$ 2,863	\$ 5,462	\$ 37,814	\$ 217,905	\$ 264,044
U.S. government and government agency obligations	13	(6,908)	(24,640)	219,363	187,828
Corporate obligations	(1,337)	3,710	11,524	30,130	44,027
Total debt securities	<u>1,539</u>	<u>2,264</u>	<u>24,698</u>	<u>467,398</u>	<u>495,899</u>
Corporate equity securities	(4,257)	—	—	—	(4,257)
Other	4,973	—	—	—	4,973
	<u>\$ 2,255</u>	<u>\$ 2,264</u>	<u>\$ 24,698</u>	<u>\$ 467,398</u>	<u>\$ 496,615</u>
Weighted average yield					
Municipal obligations	0.00 %	4.29 %	4.76 %	3.25 %	3.45 %
U.S. government and government agency obligations	0.08 %	0.72 %	1.23 %	4.83 %	4.10 %
Corporate obligations	1.05 %	2.58 %	2.48 %	2.82 %	2.57 %

Derivatives are used to support certain customer programs and hedge our related exposure to interest rate risks.

Our broker-dealer segment is engaged in various brokerage and trading activities that expose us to credit risk arising from potential non-performance from counterparties, customers or issuers of securities. This risk is managed by setting and monitoring position limits for each counterparty, conducting periodic credit reviews of counterparties, reviewing concentrations of securities and conducting business through central clearing organizations.

Collateral underlying margin loans to customers and correspondents and with respect to securities lending activities is marked to market daily and additional collateral is required as necessary.

Mortgage Origination Segment

Within our mortgage origination segment, our principal market exposure is to interest rate risk due to the impact on our mortgage-related assets and commitments, including mortgage loans held for sale, IRLCs and MSR. Changes in interest rates could also materially and adversely affect our volume of mortgage loan originations.

IRLCs represent an agreement to extend credit to a mortgage loan applicant, whereby the interest rate on the loan is set prior to funding. Our mortgage loans held for sale, which we hold in inventory while awaiting sale into the secondary market, and our IRLCs are subject to the effects of changes in mortgage interest rates from the date of the commitment through the sale of the loan into the secondary market. As a result, we are exposed to interest rate risk and related price risk during the period from the date of the lock commitment until (i) the lock commitment cancellation or expiration date or (ii) the date of sale into the secondary mortgage market. Loan commitments generally range from 20 to 60 days, and our average holding period of the mortgage loan from funding to sale is approximately 30 days. An integral component of our interest rate risk management strategy is our execution of forward commitments to sell MBSs to minimize the impact on earnings resulting from significant fluctuations in the fair value of mortgage loans held for sale and IRLCs caused by changes in interest rates.

We have expanded, and may continue to expand, our residential mortgage servicing operations within our mortgage origination segment. As a result of our mortgage servicing business, we have a portfolio of retained MSR. One of the principal risks associated with MSR 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, Eurodollar futures and forward MBS commitments, as a means to mitigate market risk associated with MSR assets. 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.

The goal of our interest rate risk management strategy within our mortgage origination segment is not to eliminate interest rate risk, but to manage it within appropriate limits. To mitigate the risk of loss, we have established policies and procedures, which include guidelines on the amount of exposure to interest rate changes we are willing to accept.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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

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

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the third fiscal quarter covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For a description of material pending legal proceedings, see the discussion set forth under the heading “Legal Matters” in Note 14 to our Consolidated Financial Statements, which is incorporated by reference herein.

Item 1A. Risk Factors.

Except as set forth below, there have been no material changes to the risk factors disclosed under “Item 1A. Risk Factors” of our 2020 Form 10-K. For additional information concerning our risk factors, please refer to “Item 1A. Risk Factors” of our 2020 Form 10-K.

Societal responses to climate change could adversely affect our business and performance, including indirectly through impacts on our customers.

Concerns over the long-term impacts of climate change have led, and will continue to lead, to governmental efforts in the United States to mitigate those impacts. Consumers and businesses also may change their behavior as a result of these concerns. We and our customers will need to respond to new laws and regulations, as well as consumer and business preferences resulting from climate change concerns. We and our customers may face cost increases, asset value reductions and operating process changes. The impact on our customers will likely vary depending on their specific attributes, including reliance on or role in carbon intensive activities. Within Texas, where our banking operations are primarily located and in which we have a significant presence for our broker-dealer and mortgage origination segments, a shift in the current state of the energy industry reflecting a transition from carbon intensive activities to low-carbon or “green” technologies and processes could have a more profound impact on our customers, consumer behavior and the economy. Among the impacts to us could be a drop in demand for our products and services, particularly in certain sectors. In addition, we could face reductions in creditworthiness on the part of some customers or in the value of assets securing loans. Our efforts to take these risks into account in making lending and other decisions may not be effective in protecting us from the negative impact of new laws and regulations or changes in consumer or business behavior.

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

The following table details our repurchases of shares of common stock during the three months ended September 30, 2021.

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)
July 1 - July 31, 2021	78,176	\$ 32.05	78,176	\$ 98,055,959
August 1 - August 31, 2021	1,704,567	33.13	1,704,567	41,580,453
September 1 - September 30, 2021	459,018	32.94	459,018	26,458,347
Total	2,241,761	\$ 33.06	2,241,761	

- (1) On January 22, 2021, we announced that our board of directors authorized a stock repurchase program under which we were originally authorized to repurchase, in the aggregate, up to \$75.0 million of our outstanding common stock through January 2022. In July 2021, our board of directors authorized an increase to the aggregate amount of common stock we may repurchase under this program by \$75.0 million to \$150.0 million. Then, in October 2021, our board of directors authorized, subject to regulatory review, an increase to the aggregate amount of common stock we may repurchase under this program by \$50.0 million to \$200.0 million, which is inclusive of repurchases to offset dilution related to grants of stock-based compensation.

Item 6. Exhibits.

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
2.1#	Stock Purchase Agreement by and among Hilltop Holdings Inc., ARC Insurance Holdings, Inc., Align NL Holdings, LLC and, for limited purposes set forth therein, Align Financial Holdings, LLC and MGI Holdings, Inc., dated January 30, 2020 (filed as Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed February 5, 2020 (File No. 001-31987) and incorporated herein by reference).
2.2#	First Amendment to Stock Purchase Agreement by and among Hilltop Holdings Inc., ARC Insurance Holdings, Inc., Align NL Holdings, LLC and, for limited purposes set forth therein, Align Financial Holdings, LLC and MGI Holdings, Inc., dated June 30, 2020 (filed as Exhibit 2.2 to the Registrant's Current Report on Form 8-K filed July 1, 2020 (File No. 001-31987) and incorporated herein by reference).
31.1*	Certification of Principal Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document – the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.
101.SCH*	Inline XBRL Taxonomy Extension Schema
101.CAL*	Inline XBRL Taxonomy Extension Calculation Linkbase
101.DEF*	Inline XBRL Taxonomy Extension Definition Linkbase
101.LAB*	Inline XBRL Taxonomy Extension Label Linkbase
101.PRE*	Inline XBRL Taxonomy Extension Presentation Linkbase
104	Cover Page Interactive File (formatted as Inline XBRL and contained in Exhibit 101)

* Filed herewith.

** Furnished herewith.

Schedules and similar attachments have been omitted from this Exhibit pursuant to Item 601(b)(2) of Regulation S-K. A copy of any omitted schedule or similar attachment will be furnished to the SEC upon request.

SIGNATURES

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

HILLTOP HOLDINGS INC.

Date: October 28, 2021

By: /s/ William B. Furr

William B. Furr

Chief Financial Officer

(Principal Financial Officer and duly authorized officer)

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

I, Jeremy B. Ford, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Hilltop Holdings Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 28, 2021

By: /s/ Jeremy B. Ford

Jeremy B. Ford
President and Chief Executive Officer

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

I, William B. Furr, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Hilltop Holdings Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 28, 2021

By: /s/ William B. Furr
William B. Furr
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q for the period ended September 30, 2021 (the “Report”) of Hilltop Holdings Inc. (the “Company”), the undersigned hereby certify in their capacities as President and Chief Executive Officer and Chief Financial Officer, respectively, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to their knowledge:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of, and for, the periods presented in the Report.

Date: October 28, 2021

By: /s/ Jeremy B. Ford
Jeremy B. Ford
President and Chief Executive Officer

Date: October 28, 2021

By: /s/ William B. Furr
William B. Furr
Chief Financial Officer

The foregoing certification is furnished as an exhibit to the Report and will not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof, regardless of any general incorporation language in such filing.