

Hilltop Holdings Inc.  
Form 10-K  
March 09, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2011

OR

- 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)

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**MARYLAND**  
(State or other jurisdiction of  
incorporation or organization)

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

**200 Crescent Court, Suite 1330**  
**Dallas, Texas**  
(Address of principal executive offices)

**75201**  
(zip code)

**(214) 855-2177**

(Registrant's telephone number, including area code)

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

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

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

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

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

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

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

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

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if smaller reporting company)

Smaller reporting company

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

The aggregate market value of the common stock of the registrant held by non-affiliates of the registrant, computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2011, was approximately \$350 million. For purposes of this computation, all officers, directors and 10% stockholders were deemed to be affiliates. This determination should not be construed as an admission that such officers, directors and 10% stockholders are affiliates. The number of shares of the registrant's common stock outstanding at March 9, 2012 was 56,502,246.

**DOCUMENTS INCORPORATED BY REFERENCE**

The Registrant's definitive Proxy Statement pertaining to the 2012 Annual Meeting of Stockholders, filed or to be filed not later than 120 days after the end of the fiscal year pursuant to Regulation 14A, is incorporated herein by reference into Part III.

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**MARKET AND INDUSTRY DATA AND FORECASTS**

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

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*Unless the context otherwise indicates, all references in this Annual Report on Form 10-K to the Company, Hilltop, HTH, we, us, our or ours or similar words are to Hilltop Holdings Inc.(formerly known as Affordable Residential Communities Inc.) and its direct and indirect wholly-owned subsidiaries.*

**FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K and the documents incorporated by reference into this report include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, or Exchange Act, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this Annual Report on Form 10-K that address results or developments that we expect or anticipate will or may occur in the future, where statements are preceded by, followed by or include the words believes, expects, may, will, would, could, should, seeks, approximately, plans, projects, estimates or anticipates or the negative of these words and phrases or similar words or phrases, including such things as our business strategy, our financial condition, our litigation, our efforts to make strategic acquisitions, our liquidity and sources of funding, our capital expenditures, our products, market trends, operations and business, 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 or further changes, 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:

- changes in the acquisition market;
- our ability to find and complete strategic acquisitions with suitable merger or acquisition candidates or find other suitable ways in which to invest our capital;
- the adverse impact of external factors, such as changes in interest rates, inflation and consumer confidence;
- the condition of capital markets;
- actual outcome of the resolution of any conflict;
- our ability to use net operating loss carryforwards to reduce future tax payments;
- the impact of the tax code and rules on our financial statements;
- failure of NLASCO, Inc.'s insurance subsidiaries to maintain their respective A.M. Best ratings;
- failure to maintain NLASCO, Inc.'s current agents;
- lack of demand for insurance products;

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- cost or availability of adequate reinsurance;
- changes in key management;
- severe catastrophic events in our geographic area;
- failure of NLASCO, Inc. s reinsurers to pay obligations under reinsurance contracts;
- failure of NLASCO, Inc. to maintain sufficient reserves for losses on insurance policies;
- failure to successfully implement NLASCO, Inc. s new information technology system; and
- failure of NLASCO, Inc. to maintain appropriate insurance licenses.

For a further discussion of these and other risks and uncertainties that could cause actual results to differ materially from those contained in our forward-looking statements, please refer to **Risk Factors** in this report. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results or developments anticipated by us will be realized, or even substantially realized, and that they will have the expected consequences to, or effects on, us and our business or operations. Forward-looking statements made in this report speak as of the date of this report or as of the date specifically referenced in any such statement set forth in this report. Except as required by law, we undertake no obligation to update or revise any forward-looking statements in this report.

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**PART I**

**ITEM 1. BUSINESS**

**General Information**

We are a holding company that is endeavoring to make opportunistic acquisitions or effect a business combination. In connection with that strategy, we are identifying and evaluating potential targets across all industries on an ongoing basis. At December 31, 2011, we had approximately \$533 million aggregate available cash and cash equivalents that may be used for this purpose. No assurances, however, can be given that we will be able to identify suitable targets, consummate acquisitions or effect a combination or, if consummated, successfully integrate or operate the acquired business.

On July, 29, 2011, we extended SWS Group, Inc, or SWS, a \$50 million term loan, which bears interest at 8% per annum, is prepayable by SWS subject to certain conditions after three years, and has a maturity of five years. SWS issued us a warrant to purchase 8,695,652 shares of SWS common stock, \$0.10 par value per share, exercisable at a price of \$5.75 per share subject to anti-dilution adjustments. If the warrant was fully exercised, we would own 17.4% of SWS. Additionally, we have purchased 1,475,387 shares of SWS common stock on the open market.

We also provide fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States through our wholly-owned property and casualty insurance holding company, NLASCO, Inc., or NLASCO. We acquired NLASCO in January 2007. NLASCO operates through its wholly-owned subsidiaries, National Lloyds Insurance Company, (NLIC), and American Summit Insurance Company, (ASIC).

NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer service and responding quickly to the needs of its agents and policyholders. NLASCO applies a high level of selectivity in the risks it underwrites and uses a risk-adjusted return approach to capital allocation, which NLASCO believes allows it to generate underwriting profits.

NLIC and ASIC carry a financial strength rating of A (Excellent) by A.M. Best. An A rating is the third highest of 16 rating categories used by A.M. Best. Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. This rating is intended to provide an independent opinion of an insurer's ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best's expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and loss adjustment expenses, and is subject to revocation or revision at any time at the sole discretion of A.M. Best.

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Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol HTH.

Our principal office is located at 200 Crescent Court, Suite 1330, Dallas, Texas 75201, and our telephone number at that location is (214) 855-2177. Our internet address is [www.hilltop-holdings.com](http://www.hilltop-holdings.com).

We currently are subject to the reporting requirements of the Exchange Act and, therefore, file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission, or the SEC. These filings, and amendments to these filings, may be accessed, free of charge, on the investor relations page of our website as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. Additionally, any materials that we file with, or furnish to, the SEC may be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for more information regarding the operations of the SEC Public Reference Room. The SEC also maintains a website, [www.sec.gov](http://www.sec.gov), which contains reports, proxy and information statements and other information regarding issuers, such as ourselves, that file electronically with the SEC. Our codes of conduct and ethics, including amendments to, and waivers of, those codes, our corporate governance guidelines, director independence criteria and board committee charters can be accessed, free of charge, on our website, as well. We will provide, at no cost, a copy of these documents upon request by telephone or in writing at the above phone number or address, attention: Investor Relations. The references to our website address do not constitute incorporation by reference of the information contained on our website into, and should not be considered a part of, this Annual Report on Form 10-K.



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In 2011, our Chief Executive Officer certified to the NYSE, pursuant to Section 303A.12 of the NYSE's listing standards, and that he is unaware of any violation by us of the NYSE's corporate governance listing standards.

**Company Background**

We were formed in 1998 under the name Affordable Residential Communities Inc. as a Maryland corporation that elected to be taxed as a real estate investment trust, or REIT. Until July 2007, we primarily engaged in the acquisition, renovation, repositioning and operation of all-age manufactured home communities, the retail sale and financing of manufactured homes, the rental of manufactured homes and other related businesses, including acting as agent in the sale of homeowners' insurance and related products, to residents and prospective residents of those communities. Our primary operations previously were conducted through an operating partnership, in which we owned a general partnership interest.

On February 18, 2004, we completed our initial public offering, or IPO. Through the year ended December 31, 2005, we operated as a fully integrated, self-administered and self-managed equity REIT for U.S. federal income tax purposes. In 2006, we revoked our election as a REIT for U.S. federal income tax purposes.

In January 2007, we acquired NLASCO. NLASCO was incorporated in Delaware in 2000, but its origins trace back to 1948 through one of its subsidiaries, NLIC.

On July 31, 2007, we sold substantially all of the operating assets used in our manufactured home communities business and our retail sales and financing business to American Residential Communities LLC. We intend to make opportunistic acquisitions with certain of the remaining proceeds from this transaction and, if necessary or appropriate, from additional equity or debt financing sources. In conjunction with this transaction, we transferred to the buyer the rights to the Affordable Residential Communities' name, changed our name to Hilltop Holdings Inc., and moved our headquarters to Dallas, Texas.

Following the completion of the sale of our manufactured home communities businesses, our current operations have consisted solely of those of NLASCO and its subsidiaries. Therefore, the remainder of our discussion focuses on the property and casualty insurance operations of NLASCO and its subsidiaries.

**Insurance Operations**

NLASCO specializes in providing fire and limited homeowners insurance for low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO has expanded its product line to include enhanced homeowners products offering higher coverage limits. NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer

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service and responding quickly to the needs of its agents and policyholders. NLASCO applies a high level of selectivity in the risks it underwrites, which we believe will generate underwriting profits.

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. Both NLIC and ASIC carry a financial strength rating of A (Excellent) by A.M. Best.

### **The Insurance Industry**

The property and casualty insurance industry provides protection from pre-specified loss events, such as damage to property or liability claims by third parties. Property and casualty insurance can be broadly classified into two lines; personal lines, in which insurance is provided to individuals, and commercial lines, in which insurance is provided to business enterprises. In the U.S., personal and commercial insurance products are written in admitted and non-admitted markets, also known as the excess and surplus lines market. NLASCO provides insurance products in the personal line and the commercial line markets.

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In the admitted market, insurers are authorized by state insurance departments to do business, insurance rates and forms are generally highly regulated and coverage tends to be standardized. Within the admitted market, NLASCO focuses on underserved segments that do not fit into the standard underwriting criteria of national insurance companies due to several factors, such as type of business, location and the amount of premium per policy. This portion of the market tends to have limited competition. Therefore, NLASCO believes it has greater flexibility in pricing and product design relative to most admitted market risks.

The non-admitted market focuses on harder-to-place risks that admitted insurers typically do not write. In this market, risks are underwritten with more flexible policy forms and rates, resulting in more restrictive and expensive coverage. NLASCO writes in this market for its dwelling fire, homeowner, and mobile home business in Louisiana.

The property and casualty insurance industry, historically, has been subject to cyclical fluctuations in pricing and availability of insurance coverage. Soft markets are often characterized by excess underwriting capital and involve intense price competition, erosion of underwriting discipline and poor operating performance. These market conditions usually lead to a period of diminished underwriting capacity after insurance companies exit unprofitable lines and exhibit greater underwriting discipline and increase premium rates. This latter market condition is called a hard market. The insurance market may not always be hard or soft; rather, it could be hard for one line of business and soft for another. The market at the start of 2012 is likely to be characterized as soft for property risks in NLASCO's operating area; however, in coastal areas, due to the hurricane activity in recent years, those markets are considered hard.

**Product Lines**

*Personal and Commercial Lines*

The NLASCO companies specialize in writing fire and homeowners insurance coverage for low value dwellings and manufactured homes. The vast majority of NLASCO's property coverage is written on policies that provide actual cash value payments, as opposed to replacement cost. Under actual cash value policies, the insured is entitled to receive only the cost of replacing or repairing damaged or destroyed property with comparable new property, less depreciation. Additionally, most of NLASCO's property policies exclude coverage for water and mold damage.

In 2010, NLASCO expanded its homeowners insurance products to include replacement cost coverage, which also includes limited water coverage. These new products are being marketed and sold in various states; however, the primary market is Texas. The development and implementation of these new products has contributed to the premium growth at NLASCO in 2011.

NLASCO's business is conducted with two product lines, its personal lines and its commercial lines. The personal lines include homeowners, dwelling fire, manufactured home, flood and vacant policies. The commercial lines include commercial, builders risk, builders risk renovation, sports liability and inland marine policies.



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Set forth below is certain financial data broken down by line of business (in millions):

	For The Year Ended December 31,		
	2011	2010	2009
<b>Gross Premiums Written</b>			
Personal lines	\$ 151.7	\$ 136.5	\$ 129.5
Commerical lines	8.7	7.9	6.7
Total	\$ 160.4	\$ 144.4	\$ 136.2
<b>Net Operating income</b>			
Personal lines	\$ 0.1	\$ 4.9	\$ 5.9
Commerical lines		2.3	0.8
Total	\$ 0.1	\$ 7.2	\$ 6.7
<b>Total Assets</b>			
Personal lines	\$ 290.2	\$ 297.5	\$ 256.3
Commerical lines	26.7	27.4	23.6
Total	\$ 316.9	\$ 324.9	\$ 279.9

**Geographic Markets**

The following table sets forth NLASCO's total gross written premiums by state for the periods shown (in millions):

	For The Year Ended December 31,		
	2011	2010	2009
<b>Gross Written Premiums</b>			
Texas - Flood	\$ 6.1	\$ 5.9	\$ 5.9
Texas - North	24.9	26.2	20.7
Texas - South	30.6	29.6	34.4
Texas - Central	16.0	9.6	9.4
Texas - West	14.0	15.5	13.0
Texas - Panhandle	7.3	7.1	6.8
Texas - East	18.0	14.1	13.4
Texas - Total	116.9	108.0	103.7
Arizona	12.4	11.3	11.3
Tennessee	9.5	8.6	7.8
Oklahoma	10.8	6.8	5.1
Georgia	4.4	3.3	1.6
Louisiana	3.0	3.0	3.0
Missouri	1.2	1.2	1.4
Nevada	1.0	1.0	1.1
All other states	1.2	1.2	1.2
TOTAL	\$ 160.4	\$ 144.4	\$ 136.2

NLASCO underwrites insurance coverage primarily in Texas. It also underwrites in other states in the south and southwest regions.



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**Distribution**

NLASCO distributes its insurance products through a broad network of independent agents in 23 states and a select number of managing general agents, referred to as MGAs. NLASCO has a preference for doing business with agents that desire a long-term relationship that will result in mutual profitability and value for both parties. NLASCO believes that relationship agents are more oriented to the long-term and desire a meaningful relationship with their customers and the insurers they represent. NLASCO's top ten agents accounted for only 10.8%, 9.9% and 9.9% of direct premiums written in 2011, 2010 and 2009, respectively, and as of December 31, 2011, the average tenure of the top 25 agencies was over 13 years.

**Underwriting and Pricing**

NLASCO applies its regional expertise, underwriting discipline and a risk-adjusted, return-on-equity based approach to capital allocation to primarily offer short-tail insurance products in its target markets. NLASCO's underwriting process involves securing an adequate level of underwriting information from its independent agents, identifying and evaluating risk exposures and then pricing the risks it chooses to accept.

NLASCO employs a disciplined underwriting approach that incorporates the continuously refined stratification of its target markets to permit it to tailor its policies to individual risks and adopt pricing structures that will be supported in the applicable market. NLASCO utilizes underwriting principles and processes that reflect the knowledge and experience it has acquired during its 40-plus year history of underwriting risks. NLASCO believes that this comprehensive process capitalizes on its knowledge and expertise and results in better underwriting decisions.

Pricing levels are established by NLASCO's senior management with the assistance of a consulting actuary. Pricing balances NLASCO's return requirements along with the legal/regulatory environment in each particular geographic region. Management reviews pricing on an ongoing basis to monitor any emerging issues. NLASCO's statistical database allows this analysis to be performed on a specific coverage or geographic territory. In 2011, ASIC increased premium rates in Arizona and NLIC increased rates in Georgia, Oklahoma, Texas and Tennessee.

**Catastrophe Exposure**

NLASCO maintains a comprehensive risk management strategy, which includes actively monitoring its catastrophe prone territories by zip code to ensure a diversified book of risks. NLASCO utilizes software and risk support from its reinsurance brokers to analyze its portfolio and catastrophe exposure. Biannually, NLASCO has its entire portfolio analyzed by its reinsurance broker who utilizes hurricane models to predict risk. Based on this information and management's active role in risk management, NLASCO makes decisions on what geographic areas to write risks. Over the years, NLASCO has adjusted its business based on its perceived risk of catastrophe losses. For example, in 2005, ASIC withdrew from the Mississippi market to mitigate its catastrophe exposure in that area, and in 2006, it stopped writing new policies that cover wind damage along the seacoast of Louisiana. In 2009, NLASCO decided not to renew wind policies for properties within the Texas seacoast. All policies in coastal areas excluded wind by the end of February 2011.

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In recent years, NLASCO's catastrophe exposure primarily resulted from property policies in Cameron, Harris, Jefferson and Nueces Counties in Texas, which include the densely populated Houston metropolitan area and the cities extending from the northern tip to the southern point on the Texas Gulf Coast. All of this territory is exposed to potential wind storm activity from the Gulf of Mexico. By not renewing wind policies on the Texas seacoast, which is exposed to the majority of potential wind storm activity, NLASCO's primary catastrophe exposure will be limited to property policies in Harris County. NLASCO also is exposed to hail and other catastrophic events in the Texas panhandle and plains states.



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**Terrorism Risk Insurance Act of 2002, Terrorism Risk Insurance Extension Act of 2005 and Terrorism Risk Insurance Program Reauthorization Act of 2007**

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 was enacted into Federal law and established the Terrorism Risk Insurance Program, or the Program. The Program is a Federal program that provides for a system of shared public and private compensation for insured losses resulting from acts of terrorism or war. The Program was scheduled to terminate on December 31, 2005. On December 22, 2005, the Terrorism Risk Insurance Extension Act of 2005 was enacted into Federal law, reauthorizing the Program through December 31, 2007, while reducing the Federal role under the Program. On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act, or the Reauthorization Act, was enacted into Federal law, reauthorizing the Program through December 31, 2014 and implementing several changes to the Program.

In order for a loss to be covered under the Program, as presently constituted, aggregate industry losses of \$100 million must be satisfied. Further, the losses must be the result of an event that is certified as an act of terrorism by the U.S. Secretary of the Treasury, Secretary of State and Attorney General. The original Program excluded from participation certain of the following types of insurance: Federal crop insurance, private mortgage insurance, financial guaranty insurance, medical malpractice insurance, health or life insurance, flood insurance and reinsurance. The 2005 Act exempted from coverage certain additional types of insurance, including commercial automobile, professional liability (other than directors and officers), surety, burglary and theft and farm-owners multi-peril. In the case of a war declared by Congress, only workers' compensation losses are covered by the Program. The Program generally requires that all commercial property and casualty insurers licensed in the United States participate in the Program. Under the Program, a participating insurer is entitled to be reimbursed by the Federal government for a percentage of subject losses, after an insurer deductible, subject to an annual cap. The Federal reimbursement percentage was fixed by the Reauthorization Act at 85%. The deductible is calculated by applying the deductible percentage to the insurer's direct earned premiums for covered lines. The deductible under the Program is fixed at 20%. NLASCO's deductible under the Program was \$1.6 million for 2011 and is estimated to be \$1.6 million in 2012. The annual cap limits the amount of aggregate subject losses for all participating insurers to \$100 billion. Once subject losses have reached \$100 billion aggregate amount during a Program year, there is no additional reimbursement from the U.S. Treasury and an insurer that has met its deductible for the program year is not liable for any losses that exceed the \$100 billion cap. When insured losses under the Program exceed the \$100 billion cap, the insured losses are subject to pro-rata sharing based upon regulations promulgated by the U.S. Treasury. Additionally, under the Reauthorization Act, the timing of mandatory recoupment of the Federal reimbursement through policyholder surcharges was accelerated.

On December 14, 2009, two final rules with respect to the Program were published in the Federal Register. The first rule describes how the Treasury will calculate the amounts to be recouped from insurers and establishes procedures for insurers to use in collecting Federal Terrorism Policy Surcharges and remitting them to the Treasury. The second rule describes how the Treasury intends to determine the pro rata share of insurance losses under the Program when losses otherwise would exceed the annual monetary cap. NLASCO had no terrorism-related losses in 2011.

**Reinsurance**

NLASCO purchases reinsurance to reduce its exposure to liability on individual risks and claims and to protect against catastrophe losses. NLASCO's management believes that less volatile, yet reasonable returns are in the long-term interest of NLASCO and, as a result, maintains a conservative reinsurance program. NLASCO generated direct premiums written totaling \$154.3 million, net of flood policies, in 2011 and paid approximately \$11.8 million in catastrophe reinsurance premiums prior to any reinstatement premiums.

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Reinsurance involves an insurance company transferring, or ceding, a portion of its risk to another insurer, the reinsurer. The reinsurer assumes the exposure in return for a portion of the premium. The ceding of risk to a reinsurer does not legally discharge the primary insurer from its liability for the full amount of the policies on which it obtains reinsurance. Accordingly, the primary insurer remains liable for the entire loss if the reinsurer fails to meet its obligations under the reinsurance agreement, and as a result, the primary insurer is exposed to the risk of non-payment by its reinsurers.

We believe that NLASCO's financial stability is substantially protected from catastrophic events through several excess of loss reinsurance contracts that combine to provide a mix of coverage against various types and combinations of catastrophe losses. As noted in the section titled Risk Factors, NLASCO is exposed to catastrophic losses that could exceed the limits of reinsurance and negatively impact its financial position and results of operations. The Company purchases catastrophe excess of loss reinsurance to a limit that exceeds the Hurricane 200-year return time as modeled by RMS Risk Link v. 11.0 and exceeds the Hurricane 500-year return time as modeled by AIR Classic v 13.0.

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In formulating its reinsurance programs, NLASCO believes that it is selective in its choice of reinsurers and considers numerous factors, the most important of which are the financial stability of the reinsurer, its history of responding to claims and its overall reputation. In an effort to minimize exposure to the insolvency of reinsurers, NLASCO evaluates the acceptability, and continuously monitors the financial condition, of each reinsurer. NLASCO enters into reinsurance agreements only with reinsurers that have an A.M. Best financial strength rating of A- (Excellent) (fourth highest of 16 categories) or better, or at least an A rating by Standard & Poors. If a reinsurer rating subsequently drops below A- (Excellent), NLASCO can cancel or replace the reinsurer. As of December 31, 2011, 100% of NLASCO's paid loss recoverables were from reinsurers rated A- (Excellent) or better by A.M. Best. To further minimize exposure to reinsurer insolvency, NLASCO spreads reinsurance treaties among many reinsurers. NLASCO reviews retention levels each year to maintain a balance between the growth in surplus and the cost of reinsurance. NLASCO had no losses from unrecoverable reinsurance in 2011.

NLASCO's ten largest net receivable balances from reinsurers as of, and for the year ended, December 31, 2011 were as follows (in millions):

	A.M. Best Financial Strength Rating	Year Ended December 31, 2011			
		Ceded Premiums	Balances Due from Reinsurance Companies	Prepaid Reinsurance Premiums	Net Receivable Balance(1)
Federal Emergency Management Agency	N/A	\$ 6.1	\$ 1.1	\$ 5.1	\$ 6.2
Endurance Specialty Insurance Ltd	A		3.3		3.3
Ariel Reinsurance Company Limited	A-	0.6	1.1		1.1
Platinum Underwriters Reinsurance, Inc.	A	0.4	2.4		2.4
Munich Reinsurance America, Inc.	A+	1.1	1.6		1.6
MS Frontier Reinsurance Limited	A	0.1	1.6		1.6
Arch Reinsurance Company	A	1.4	1.3		1.3
Validus Reinsurance Ltd	A		1.2		1.2
Paladin Catastrophe Management LLC	A+		1.1		1.1
Amlin AG	A	0.7	1.1		1.1

(1) The net receivable balance includes balances due from reinsurance companies, contingent commissions, prepaid reinsurance premiums and ceded contingent commissions, less balances due to reinsurance companies.

As of December 31, 2011, NLASCO had five layers of catastrophic excess of loss reinsurance coverage up to \$170 million of losses per event in excess of \$1 million retention by ASIC and \$8 million retention by NLIC. The reinsurance from \$8 million to \$50 million loss is comprised of two layers of protection: \$17 million in excess of \$8 million loss; \$25 million in excess of \$25 million loss. The third layer provides coverage for \$50 million in excess of \$50 million loss; the fourth layer provides coverage of \$50 million in excess of \$100 million loss and the fifth layer provides coverage of \$20 million in excess of \$150 million loss. The fifth layer is not fully subscribed, with participants accounting for 79% of the total layer. Accordingly, NLASCO retains 21% of the losses in the fifth layer. NLIC and ASIC retain no participation in any of the other layers, beyond the first \$8 million and \$1.0 million, respectively.

As of January 1, 2012, the Company renewed its reinsurance contract for its first and second layers of reinsurance. Per the contract renewal, NLASCO changed its underlying coverage at ASIC to \$6.5 million in excess of \$1.5 million retention. The reinsurance in excess of \$8 million is comprised of five layers of protection: \$17 million in excess of \$8 million retention; \$25 million in excess of \$25 million loss; \$50 million in excess of \$50 million loss; \$50 million in excess of \$100 million loss and \$20 million in excess of \$150 million loss. The fifth layer is not fully

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subscribed, with participants accounting for 79% of the total layer. NLIC and ASIC retain no participation in any of the layers, other than the first \$8 million and \$1.5 million retention, respectively. The projected premiums on these treaties for NLIC and ASIC are \$10.1 and \$2.8 million, respectively, in 2012.

As of December 31, 2011, total retention for any one catastrophe that affects both NLIC and ASIC is limited to \$8 million in the aggregate.

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In addition to the catastrophe reinsurance noted above, both NLIC and ASIC participate in an excess of loss program with General Reinsurance Corporation. The General Reinsurance Corporation program is limited to each risk with respect to property and liability in the amount of \$800,000 for each of NLIC and ASIC. Each of NLIC and ASIC retain \$200,000 in this program. On January 1, 2012, the program will limit each risk for property and liability in the amount of \$775,000 for each NLIC and ASIC, with the retention increasing to \$225,000.

**Liabilities for Unpaid Losses and Loss Adjustment Expenses**

NLASCO's liabilities for losses and loss adjustment expenses include liabilities for reported losses, liabilities for incurred but not reported, or IBNR, losses and liabilities for loss adjustment expenses, or LAE, less a reduction for reinsurance recoverables related to those liabilities. The amount of liabilities for reported claims is based primarily on a claim-by-claim evaluation of coverage, liability, injury severity or scope of property damage, and any other information considered relevant to estimating exposure presented by the claim. The amounts of liabilities for IBNR losses and LAE are estimated on the basis of historical trends, adjusted for changes in loss costs, underwriting standards, policy provisions, product mix and other factors. Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors that are subject to significant variation. Liabilities for LAE are intended to cover the ultimate cost of settling claims, including investigation and defense of lawsuits resulting from such claims. Based upon the contractual terms of the reinsurance agreements, reinsurance recoverables offset, in part, NLASCO's gross liabilities.

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer and the insurer's payment of that loss. NLASCO's liabilities for unpaid losses represent the best estimate at a given point in time of what it expects to pay claimants, based on facts, circumstances and historical trends then known. During the loss settlement period, additional facts regarding individual claims may become known and, consequently, it often becomes necessary to refine and adjust the estimates of liability.

The table below presents one-year development information on changes in the liability for losses and LAE and a reconciliation of liabilities on a direct premiums written and net premiums written basis for the twelve months ended December 31, 2011 and 2010 (in thousands):

	2011	2010
Balance at January 1,	\$ 58,882	\$ 33,780
Less reinsurance recoverables	(43,773)	(21,102)
Net balance at January 1,	15,109	12,678
Incurred related to:		
Current Year	97,742	69,044
Prior Period	(1,008)	1,899
Total incurred	96,734	70,943
Payments related to:		
Current Year	(83,266)	(59,560)
Prior Year	(8,825)	(8,952)
Total payments	(92,091)	(68,512)
Net balance at December 31,	19,752	15,109
Plus reinsurance recoverables	25,083	43,773
Balance at December 31,	\$ 44,835	\$ 58,882

The decrease in reserves for the twelve months ended December 31, 2011, as compared to the same period in 2010, of \$14.0 million is due to a decrease in reinsurance recoverables of \$18.7 million. Reinsurance recoverables decreased due to settling reserves and paying claims related to Hurricane Ike, Hurricane Dolly and the 2010 Arizona Storm. Incurred related to current year increased \$28.7 million for the twelve months ended December 31, 2011, as compared to the same period in 2010, due to increases in frequency and severity of fire losses and wind and hail losses, as well as the effects of five storms that occurred in Texas in April and May 2011. Incurred amounts related to prior years indicate that we had favorable IBNR development as of December 31, 2010, resulting in a benefit in the twelve months ended December 31, 2011. This redundancy is due to favorable development on our homeowners and fire products for the 2008 and 2009 accident years, offset by unfavorable development for the 2010 accident year.

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For the twelve months ended December 31, 2011 and 2010, the reserve for losses and loss adjustment expenses includes amounts related to losses incurred prior to the purchase of NLASCO. All losses and payments related to events that occurred prior to the purchase of NLASCO were the responsibility of the sellers. In March 2011, we made a final settlement with the sellers and going forward all losses are the responsibility of the Company.

**Loss Development**

NLASCO estimates the aggregate amount of losses and LAE ultimately required to settle all claims for a given period. The following tables present the development of estimated liability for losses and LAE, net of reinsurance, for the years 2001 through 2010 of NLIC and ASIC. These tables present accident or policy year development data. The first line of the table shows, for the years indicated, net liability, including IBNR, as originally estimated. For example, as of December 31, 2002, NLIC estimated that \$18.1 million would be a sufficient net liability to settle all unsettled claims retained by it that had occurred prior to December 31, 2002, whether reported or unreported. The next section of the table sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. For example, as indicated in that section of the table, the original net liability of \$18.1 million was re-estimated to be \$17.3 million at December 31, 2006 (four years later). The decrease in the original estimate is caused by a combination of factors, including: (1) claims being settled for amounts different than originally estimated; (2) the net liability being increased or decreased for claims remaining open as more information becomes known about those individual claims; and (3) more or fewer claims being reported after December 31, 2002 than had occurred prior to that date. The bottom section of the table shows, by year, the cumulative amounts of net losses and LAE paid as of the end of each succeeding year. For example, with respect to the liability for net losses and LAE of \$18.1 million as of December 31, 2002, by the end of 2006 (four years later), \$17.2 million had actually been paid in settlement of the claims.

The net cumulative redundancy (deficiency) represents, as of December 31, 2011, the difference between the latest re-estimated net liability and the net liability as originally estimated for losses and LAE retained by us. A redundancy means the original estimate was higher than the current estimate; and a deficiency means that the original estimate was lower than the current estimate. For example, as of December 31, 2011 and based upon updated information, NLIC re-estimated that the net liability that was established as of December 31, 2002 was \$0.8 million redundant.

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The following tables are presented net of reinsurance recoverable.

**National Lloyds Insurance Company  
Analysis of Loss Reserve Development  
(Dollars in Thousands)**

	Year Ended December 31,									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Original Reserve*	18,141	35,061	33,951	41,282	47,684	44,613	65,592	60,392	55,482	81,589
1 year later	17,852	32,887	28,106	36,332	43,640	44,064	64,864	62,337	54,987	
2 years later	17,281	32,559	27,593	40,391	43,465	44,134	65,070	62,014		
3 years later	17,357	31,614	25,747	41,231	43,394	43,950	64,702			
4 years later	17,340	31,030	25,712	39,735	43,387	43,788				
5 years later	17,312	31,088	25,579	39,699	43,366					
6 years later	17,332	31,072	25,582	39,675						
7 years later	17,321	31,066	25,568							
8 years later	17,307	31,056								
9 years later	17,306									
Net cumulative redundancy (deficiency)	835	4,005	8,383	1,607	4,318	825	890	(1,622)	495	
Cumulative amount of net liability paid as of:										
1 year later	16,836	30,867	24,747	32,871	42,301	42,478	63,761	59,977	53,387	
2 years later	17,160	30,818	25,149	34,625	42,668	43,245	64,203	60,517		
3 years later	17,209	30,875	25,388	36,157	43,140	43,495	64,391			
4 years later	17,231	30,989	25,462	39,533	43,361	43,563				
5 years later	17,287	31,026	25,521	39,646	43,365					
6 years later	17,300	31,030	25,538	39,674						
7 years later	17,301	31,029	25,564							
8 years later	17,302	31,051								
9 years later	17,302									

\* Including amounts paid in respective year.



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**American Summit Insurance Company**  
**Analysis of Loss Reserve Development**  
**(Dollars in Thousands)**

	Year Ended December 31,									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Original Reserve*	11,873	6,235	8,297	11,041	13,003	9,351	12,769	9,773	12,486	14,829
1 year later	11,983	5,322	7,388	9,932	13,014	9,154	12,009	9,423	13,153	
2 years later	11,963	5,512	6,999	9,918	12,998	9,335	11,943	9,088		
3 years later	11,554	5,563	6,859	9,918	13,435	9,235	11,880			
4 years later	11,749	5,401	6,772	9,797	13,216	9,200				
5 years later	11,775	5,396	6,714	9,820	13,195					
6 years later	11,799	5,394	6,787	9,815						
7 years later	11,804	5,396	6,743							
8 years later	11,833	5,417								
9 years later	11,821									
Net cumulative redundancy (deficiency)	52	818	1,554	1,226	(192)	151	889	685	(667)	
Cumulative amount of net liability paid as of:										
1 year later	10,909	4,987	6,566	9,341	12,429	8,732	11,560	8,800	12,390	
2 years later	11,284	5,612	6,610	9,578	12,639	9,095	11,637	8,803		
3 years later	11,647	5,756	6,682	9,679	13,326	9,193	11,726			
4 years later	11,727	5,393	6,699	9,740	13,161	9,196				
5 years later	11,747	5,393	6,714	9,813	13,188					
6 years later	11,759	5,394	6,720	9,813						
7 years later	11,764	5,394	6,723							
8 years later	11,821	5,417								
9 years later	11,821									

\* Including amounts paid in respective year.

Please refer to Note 8 in the notes to consolidated financial statements for a reconciliation of the reserves presented in the tables above to the reserves for losses and loss adjustment expenses set forth in the balance sheet at December 31, 2011 and 2010.

Current loss reserve development has been favorable with the exception of accident years 2009 and 2010. In the accident years 2007 and 2008, the developed reserves as of December 31, 2011 were \$1.0 million and \$1.8 million, respectively, less than the initial carried reserve for each year. During accident year 2009, however, loss development was unfavorable by \$0.9 million due to unfavorable development at NLIC of \$1.6 million. The unfavorable development at NLIC in accident year 2009 is due to adverse development on our homeowners and fire products of \$1.0 million and \$0.5 million, respectively. During accident year 2010, the loss development was unfavorable by \$0.2 million due to unfavorable development at ASIC of \$0.7 million. The unfavorable development at ASIC in accident year 2010 is due to adverse development on homeowners products of \$0.4 million. For the accident years 2002 through 2006, the reserves were \$22.6 million favorable. Starting in 2002, IBNR loss reserves were strengthened, contributing to the favorable development in accident years 2002, 2003 and 2004. This

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strengthening of reserves was due to increases in direct premium written and increased net premium written from reductions in quota share reinsurance, a form of pro rata insurance.

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The following table is a reconciliation of the gross liability to net liability for losses and loss adjustment expenses (dollars in thousands).

	2002	2003	2004	2005	Year Ended December 31, *		2009	2010	2011	
					2006	2007**	2008			
<b>Gross unpaid losses</b>										
Consolidated balance sheet	n/a	n/a	n/a	n/a	n/a	\$ 18,091	\$ 34,023	\$ 33,780	\$ 58,882	\$ 44,835
Reinsurance recoverable	n/a	n/a	n/a	n/a	n/a	(2,692)	(14,613)	(21,102)	(43,773)	(25,083)
Net unpaid losses	n/a	n/a	n/a	n/a	n/a	\$ 15,399	\$ 19,410	\$ 12,678	\$ 15,109	\$ 19,752

\* Information is not presented for periods prior to January 31, 2007, as that is the date Hilltop Holdings Inc. acquired the insurance operations.

\*\* Only includes eleven months, as the insurance operations were acquired on January 31, 2007.

### **Ratings**

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. The ratings for NLIC and ASIC of A (Excellent) were affirmed by A.M. Best in April 2011. An A rating is the third highest of 16 rating categories used by A.M. Best. In evaluating a company's financial and operating performance, A.M. Best reviews a company's profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its liabilities for losses and LAE, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. This rating is intended to provide an independent opinion of an insurer's ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best's expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and LAE, and is subject to revocation or revision at any time at the sole discretion of A.M. Best. NLASCO cannot ensure that NLIC and ASIC will maintain their present ratings.

### **Investments**

HTH's primary investment objectives, as a holding company, are to preserve capital and possess available cash resources to utilize in making opportunistic acquisitions. Accordingly, HTH, parent only, has \$533.4 million in short-term cash equivalents, \$10.1 million in equity securities and \$60.4 million in other investments as of December 31, 2011. HTH's management regularly monitors investment performance.

Our insurance operating subsidiary, NLASCO, has primary investment objectives to preserve capital and manage for a total rate of return. The investment strategy of NLASCO's insurance subsidiaries is to purchase securities in sectors that represent what is expected to possess the most attractive relative value. Bonds, cash and short-term investments constituted \$197.2 million, or 95.7%, of NLASCO's investments at December

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31, 2011, of which \$7.3 million represents an investment in HTH Senior Exchangeable Notes, and is, therefore, eliminated in consolidation. NLASCO insurance subsidiaries have custodial agreements with A.G. Edwards and Wells Fargo Bank and an investment management agreement with DTF Holdings, LLC.

NLASCO's investment guidelines reflect the desire and intent to assure the prudent investment of capital and surplus, keeping in mind the long-term nature of some insurance reserves, while recognizing the uncertainty of expected cash flows, the shorter term characteristics of and the desire to supplement insurance underwriting gains and offset losses with portfolio income and realized gains in order to maintain adequate capital and surplus. All investments are made in compliance with all state and Federal laws and regulations applicable to such investments and the company involved. State insurance laws and regulations limit the amount of investments in asset classes below certain quality levels. NLASCO currently maintains a quality structure exceeding the minimum requirements imposed on the portfolio by state insurance laws and regulations, which is known as the Investment of Insurer's Model Act, or National Association of Insurance Commissioners Act. Currently, NLASCO has no investments in subprime mortgages.

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Liquidity and preservation of policyholder surplus can be limiting factors in achieving a favorable return on invested assets, as sufficient funds need to be maintained to meet ongoing near term financial obligations. Funds not immediately needed to offset withdrawals may be invested in short-term securities on a continuous basis. A maturity structure must be maintained to invest cash flows from operations and reinvest investment income, as well as to provide a source of liquidity and flexibility to meet changing market, tax and other operating considerations.

Notwithstanding the above, the underlying objective of NLASCO's investment policy is to obtain a favorable total return on invested assets to augment the growth of surplus from operations. Total return comes both from income and capital growth, so a portion of the funds are invested in assets other than fixed income securities, including common stocks and growth oriented preferred stocks. In managing these investment choices, market volatility, the absolute level of NLASCO's capital and surplus relative both to existing liabilities and the level of premium revenue, as well as to total assets, are the limiting factors that influence the portion of assets invested in assets other than fixed income investments.

Performance is measured by comparing the total return, for each period, of each major sector of NLASCO's investment portfolio to an appropriate market index, as well as comparing the total return of NLASCO's investment portfolio to an average of the market indices, weighted by the portfolio's average exposure to each other particular sector during the period. The assets are managed with volatility of return similar to or less than the indices.

HTH's investment committee meets regularly to review the portfolio performance and investment markets in general. NLASCO's management generally meets monthly to review the performance of investments and monitor market conditions for investments that would warrant any revision to investment guidelines.

The following table sets forth information concerning the composition of the investment portfolio at December 31, 2011 (in thousands):

	Cost/Amortized Cost	December 31, 2011 Fair Value	December 31, 2011 Carrying Value	Percent of Carrying Value
<b>Available-for-sale securities:</b>				
<b>Fixed maturities:</b>				
Government securities	\$ 27,729	\$ 29,165	\$ 29,165	13.0%
Residential mortgage-backed securities	11,708	12,652	12,652	5.6%
Commercial mortgage-backed securities	2,277	2,303	2,303	1.0%
Corporate debt securities	93,452	100,681	100,681	44.9%
	135,166	144,801	144,801	
Equity securities	16,813	19,022	19,022	8.5%
	151,979	163,823	163,823	
<b>Other investments:</b>				
Note receivable	38,641	38,588	38,588	17.2%
Warrants	12,068	21,789	21,789	9.7%
	\$ 202,688	\$ 224,200	\$ 224,200	100.0%

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At December 31, 2011, NLASCO's fixed maturity portfolio had a fair value of approximately \$144.8 million. All of the fixed maturity investments are rated as investment grade. As a result, the market value of these investments may fluctuate in response to changes in interest rates. In addition, we may experience investment losses to the extent our liquidity needs require disposition of fixed maturity securities in unfavorable interest rate environments.

The equity securities of \$19.0 million consist of \$10.1 million in common stocks held by HTH and \$8.9 million in common and preferred stocks held by NLASCO. Other investments represent the value of the note receivable and warrants held at HTH.

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The amortized cost (original cost for equity securities and other investments), gross unrealized holding gains and losses, and fair value of available-for-sale securities by major security type and class of security at December 31, 2011 for the investment portfolio were as follows (in thousands).

	<b>December 31, 2011</b>			
	<b>Cost/Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>Available-for-sale securities:</b>				
<b>Fixed maturities:</b>				
Government securities	\$ 27,729	\$ 1,439	\$ (3)	\$ 29,165
Residential mortgage-backed securities	11,708	944		12,652
Commercial mortgage-backed securities	2,277	36	(10)	2,303
Corporate debt securities	93,452	7,406	(177)	100,681
	135,166	9,825	(190)	144,801
<b>Equity securities</b>	<b>16,813</b>	<b>2,462</b>	<b>(253)</b>	<b>19,022</b>
	151,979	12,287	(443)	163,823
<b>Other investments:</b>				
Note receivable	38,641		(53)	38,588
Warrants	12,068	9,721		21,789
	\$ 202,688	\$ 22,008	\$ (496)	\$ 224,200

For the twelve months ended December 31, 2011, the Company did not record any other-than-temporary impairments. While all of the investments are monitored for potential other-than-temporary impairment, our analysis and experience indicate that these investments generally do not present a great risk of other-than-temporary-impairment, as fair value should recover over time. Factors considered in our analysis include the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the investment portfolio have decreased in value since the date of acquisition, the severity of loss and the duration of the loss position are not believed to be significant enough to warrant other-than-temporary impairment of the securities. The Company does not intend, nor is it likely that the Company will be required, to sell these securities before the recovery of the cost basis; and, therefore, we do not believe any other-than-temporary impairment exist as of December 31, 2011.

During 2010 and 2009, the Company took other-than-temporary impairments and recognized a loss in earnings of \$70,000 and \$0.8 million, respectively.

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The following table presents the maturity profile of the fixed maturity investments as of December 31, 2011. Actual maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities available-for-sale at December 31, 2011 by contractual maturity is as follows (in thousands).

	December 31, 2011	
	Amortized Cost	Fair Value
Available-for-sale fixed maturities:		
Due within one year	\$ 12,608	\$ 12,942
Due after one year through five years	69,594	73,300
Due six years through ten years	38,065	42,766
Due after ten years	914	838
Mortgage-backed securities	13,985	14,955
	\$ 135,166	\$ 144,801
Other Investments:		
Due after one year through five years	\$ 50,709	\$ 60,377
	\$ 50,709	\$ 60,377

We are subject to various market risk exposures, including interest rate risk and equity price risk. Our primary risk exposure is to changes in interest rates. We manage market risk through our investment committee and through the use of an outside professional investment management firm. We are vulnerable to interest rate changes, like other insurance companies, because we invest primarily in fixed maturity securities, which are interest-sensitive assets. Mortgage-backed securities, which make up approximately 10.3% of our available-for-sale fixed maturities, are particularly susceptible to interest rate changes.

The value of our equity investments is dependent upon general conditions in the securities markets and the business and financial performance of the individual companies in the portfolio. Values are typically based on future economic prospects that are perceived by investors in the equity market.

**Competition**

NLASCO competes with a large number of other companies in its selected lines of business, including major U.S. and non-U.S. insurers, regional companies, mutual companies, specialty insurance companies, underwriting agencies and diversified financial services companies. The personal lines market in Texas is dominated by a few large carriers and their subsidiaries and affiliates, including State Farm, Zurich Insurance Group, Allstate and USAA. According to the Texas Department of Insurance, the top ten insurers writing homeowners insurance accounted for approximately 81.6% of the market for the trailing twelve months at September 30, 2011. NLASCO competes for business on the basis of a number of factors, including price, coverages offered, customer service, relationships with agents (including ease of doing business, service provided and commission rates paid), size and financial strength ratings. In its personal lines business, NLASCO's competitors include Republic Companies Group, Inc., Columbia Lloyds, Foremost, American Modern Home Group and American Reliable. In its commercial lines business, NLASCO's competitors include Travelers, Safeco and Republic. NLASCO seeks to distinguish itself from its competitors by targeting underserved market segments that provide NLASCO with the best opportunity to obtain favorable policy terms, conditions and pricing.

**Regulation of Insurance Activities**



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

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*State insurance holding company regulation*

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

*Changes of control*

Before a person can acquire control of an insurance company domiciled in Texas, prior written approval must be obtained from the Texas Department of Insurance. Prior to granting approval of an application to acquire control of an insurer, the Texas Department of Insurance will consider the following factors, among others:

- the financial strength of the applicant;
- the integrity and management experience of the applicant's board of directors and executive officers;
- the acquirer's plans for the management of the domestic insurer;
- the acquirer's plans to declare dividends, sell assets or incur debt;
- the acquirer's plans for the future operations of the domestic insurer;
- the impact of the acquisition on continued licensure of the domestic insurer;
- the impact on the interests of Texas policyholders; and

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- any anti-competitive results that may arise from the consummation of the acquisition of control.

Pursuant to the Texas insurance holding company statutes, control means the possession, direct or indirect, of the power to direct, or cause the direction of, the management and policies of the company, whether through the ownership of voting securities, by contract (except a commercial contract for goods or non-management services) or otherwise. Control is presumed to exist if any person directly or indirectly owns, controls or holds with the power to vote 10% or more of the voting securities of the company; however, the state's insurance department, after notice and a hearing, may determine that a person or entity that directly or indirectly owns, controls or holds with the power to vote less than 10% of the voting securities of the company nonetheless controls the company. Because a person acquiring 10% or more of HTH's common stock would indirectly control the same percentage of the stock of ASIC and two affiliated corporations controlling NLIC, the change of control laws of the State of Texas would apply to such a transaction.

These laws may discourage potential acquisition proposals and may delay, deter or prevent change of control transactions, including those that some or all of the Company's stockholders might consider to be desirable.

### *National Association of Insurance Commissioners*

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

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