

Territorial Bancorp Inc.  
Form 10-Q  
November 06, 2015  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**For the Quarterly Period ended September 30, 2015**

**or**

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

**For transition period from                      to**

**Commission File Number 1-34403**

**TERRITORIAL BANCORP INC.**

(Exact Name of Registrant as Specified in Charter)

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**Maryland**  
(State or Other Jurisdiction of Incorporation)

**26-4674701**  
(I.R.S. Employer Identification No.)

**1132 Bishop Street, Suite 2200, Honolulu, Hawaii**  
(Address of Principal Executive Offices)

**96813**  
(Zip Code)

**(808) 946-1400**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name or former address, if changed since last report)

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  NO .

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: 9,680,322 shares of Common Stock, par value \$0.01 per share, were issued and outstanding as of October 31, 2015.



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**TERRITORIAL BANCORP INC.**

Form 10-Q Quarterly Report

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Table of Contents**PART I****ITEM 1. FINANCIAL STATEMENTS****TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Balance Sheets (Unaudited)****(Dollars in thousands, except share data)**

|   | September 30,<br>2015 | December 31,<br>2014 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and cash equivalents   | \$ 39,466             | \$ 75,060            |
| Investment securities held to maturity, at amortized cost (fair value of \$520,534 and \$586,710 at September 30, 2015 and December 31, 2014, respectively)                   | 508,747               | 572,922              |
| Loans held for sale   | 225                   | 1,048                |
| Loans receivable, net   | 1,163,292             | 968,212              |
| Federal Home Loan Bank stock, at cost   | 4,590                 | 11,234               |
| Federal Reserve Bank stock, at cost   | 2,989                 | 2,925                |
| Accrued interest receivable   | 4,742                 | 4,436                |
| Premises and equipment, net   | 5,026                 | 5,629                |
| Bank-owned life insurance   | 42,072                | 41,303               |
| Current income taxes receivable   | 1,523                 |                      |
| Deferred income taxes receivable  | 8,366                 | 7,254                |
| Prepaid expenses and other assets   | 2,477                 | 1,874                |
| <b>Total assets</b>   | <b>\$ 1,783,515</b>   | <b>\$ 1,691,897</b>  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                       |                      |
| Liabilities:  |                       |                      |
| Deposits  | \$ 1,412,997          | \$ 1,359,679         |
| Advances from the Federal Home Loan Bank  | 64,000                | 15,000               |
| Securities sold under agreements to repurchase  | 55,000                | 72,000               |
| Accounts payable and accrued expenses   | 28,582                | 24,098               |
| Current income taxes payable  | 1,476                 | 826                  |
| Advance payments by borrowers for taxes and insurance   | 3,094                 | 3,916                |
| <b>Total liabilities</b>  | <b>1,565,149</b>      | <b>1,475,519</b>     |
| Stockholders Equity:  |                       |                      |
| Preferred stock, \$.01 par value; authorized 50,000,000 shares, no shares issued or outstanding   |                       |                      |
| Common stock, \$.01 par value; authorized 100,000,000 shares; issued and outstanding 9,698,420 and 9,919,064 shares at September 30, 2015 and December 31, 2014, respectively | 97                    | 99                   |
| Additional paid-in capital  | 70,295                | 75,229               |
| Unearned ESOP shares  | (6,484)               | (6,851)              |
| Retained earnings   | 159,785               | 153,289              |

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|  |              |              |
|--|--------------|--------------|
| Accumulated other comprehensive loss       | (5,327)      | (5,388)      |
| Total stockholders' equity                 | 218,366      | 216,378      |
| Total liabilities and stockholders' equity | \$ 1,783,515 | \$ 1,691,897 |

See accompanying notes to consolidated financial statements.

Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Income (Unaudited)**

(Dollars in thousands, except per share data)

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2015                                | 2014      | 2015                               | 2014      |
| <b>Interest and dividend income:</b>                |                                     |           |                                    |           |
| Loans   | \$ 11,809                           | \$ 10,020 | \$ 33,761                          | \$ 29,320 |
| Investment securities                               | 4,098                               | 4,895     | 12,895                             | 15,055    |
| Other investments                                   | 64                                  | 75        | 213                                | 153       |
| Total interest and dividend income                  | 15,971                              | 14,990    | 46,869                             | 44,528    |
| <b>Interest expense:</b>                            |                                     |           |                                    |           |
| Deposits  | 1,198                               | 1,138     | 3,486                              | 3,332     |
| Advances from the Federal Home Loan Bank            | 211                                 | 67        | 438                                | 199       |
| Securities sold under agreements to repurchase      | 221                                 | 346       | 776                                | 1,032     |
| Total interest expense                              | 1,630                               | 1,551     | 4,700                              | 4,563     |
| Net interest income                                 | 14,341                              | 13,439    | 42,169                             | 39,965    |
| Provision for loan losses                           | 71                                  | 23        | 366                                | 188       |
| Net interest income after provision for loan losses | 14,270                              | 13,416    | 41,803                             | 39,777    |
| <b>Noninterest income:</b>                          |                                     |           |                                    |           |
| Service fees on loan and deposit accounts           | 590                                 | 555       | 1,577                              | 1,578     |
| Income on bank-owned life insurance                 | 259                                 | 265       | 770                                | 797       |
| Gain on sale of investment securities               |                                     | 392       | 476                                | 1,047     |
| Gain on sale of loans                               | 201                                 | 118       | 440                                | 283       |
| Other   | 138                                 | 68        | 419                                | 330       |
| Total noninterest income                            | 1,188                               | 1,398     | 3,682                              | 4,035     |
| <b>Noninterest expense:</b>                         |                                     |           |                                    |           |
| Salaries and employee benefits                      | 5,596                               | 5,402     | 15,759                             | 16,062    |
| Occupancy   | 1,483                               | 1,474     | 4,348                              | 4,305     |
| Equipment   | 1,025                               | 956       | 2,923                              | 2,775     |
| Federal deposit insurance premiums                  | 214                                 | 202       | 634                                | 602       |
| Other general and administrative expenses           | 1,048                               | 1,045     | 3,449                              | 2,946     |
| Total noninterest expense                           | 9,366                               | 9,079     | 27,113                             | 26,690    |
| Income before income taxes                          | 6,092                               | 5,735     | 18,372                             | 17,122    |
| Income taxes  | 2,406                               | 2,273     | 7,323                              | 6,479     |
| Net income  | \$ 3,686                            | \$ 3,462  | \$ 11,049                          | \$ 10,643 |
| Basic earnings per share                            | \$ 0.41                             | \$ 0.38   | \$ 1.22                            | \$ 1.16   |
| Diluted earnings per share                          | \$ 0.40                             | \$ 0.37   | \$ 1.19                            | \$ 1.15   |
| Cash dividends declared per common share            | \$ 0.17                             | \$ 0.15   | \$ 0.49                            | \$ 0.44   |
| Basic weighted-average shares outstanding           | 9,085,725                           | 9,218,745 | 9,086,481                          | 9,190,476 |
| Diluted weighted-average shares outstanding         | 9,301,500                           | 9,323,306 | 9,250,835                          | 9,283,425 |

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See accompanying notes to consolidated financial statements.



Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Unaudited)**

(Dollars in thousands)

|  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|----------|------------------------------------|-----------|
|  | 2015                                | 2014     | 2015                               | 2014      |
| Net income   | \$ 3,686                            | \$ 3,462 | \$ 11,049                          | \$ 10,643 |
| Change in unfunded pension liability                           |                                     |          | (64)                               |           |
| Change in unrealized loss on securities                        | 8                                   | 1        | 24                                 | 5         |
| Change in noncredit related loss on trust preferred securities | (7)                                 | 3        | 101                                | 75        |
| Other comprehensive income, net of tax                         | 1                                   | 4        | 61                                 | 80        |
| Comprehensive income   | \$ 3,687                            | \$ 3,466 | \$ 11,110                          | \$ 10,723 |

See accompanying notes to consolidated financial statements.

Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders Equity (Unaudited)**

(Dollars in thousands, except per share data)

|  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>(Loss)/Income | Total<br>Stockholders<br>Equity |
|--|-----------------|----------------------------------|----------------------------|----------------------|--|---------------------------------|
| Balances at December 31, 2013                        | \$ 101          | \$ 77,340                        | \$ (7,340)                 | \$ 145,826           | \$ (3,787)   | \$ 212,140                      |
| Net income   |                 |                                  |                            | 10,643               |  | 10,643                          |
| Other comprehensive income                           |                 |                                  |                            |                      | 80   | 80                              |
| Cash dividends declared (\$0.44 per share)           |                 |                                  |                            | (4,174)              |  | (4,174)                         |
| Share-based compensation                             | 1               | 2,001                            |                            |                      |  | 2,002                           |
| Allocation of 36,699 ESOP shares                     |                 | 410                              | 367                        |                      |  | 777                             |
| Repurchase of 195,109 shares of company common stock | (2)             | (4,380)                          |                            |                      |  | (4,382)                         |
| Balances at September 30, 2014                       | \$ 100          | \$ 75,371                        | \$ (6,973)                 | \$ 152,295           | \$ (3,707)   | \$ 217,086                      |
| Balances at December 31, 2014                        | \$ 99           | \$ 75,229                        | \$ (6,851)                 | \$ 153,289           | \$ (5,388)   | \$ 216,378                      |
| Net income   |                 |                                  |                            | 11,049               |  | 11,049                          |
| Other comprehensive income                           |                 |                                  |                            |                      | 61   | 61                              |
| Cash dividends declared (\$0.49 per share)           |                 |                                  |                            | (4,553)              |  | (4,553)                         |
| Share-based compensation                             | 1               | 2,416                            |                            |                      |  | 2,417                           |
| Allocation of 36,699 ESOP shares                     |                 | 499                              | 367                        |                      |  | 866                             |
| Repurchase of 334,976 shares of company common stock | (3)             | (7,866)                          |                            |                      |  | (7,869)                         |
| Exercise of 1,000 options of common stock            |                 | 17                               |                            |                      |  | 17                              |
| Balances at September 30, 2015                       | \$ 97           | \$ 70,295                        | \$ (6,484)                 | \$ 159,785           | \$ (5,327)   | \$ 218,366                      |

See accompanying notes to consolidated financial statements.

Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Unaudited)**

(Dollars in thousands)

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2015                               | 2014      |
| <b>Cash flows from operating activities:</b>                               |                                    |           |
| Net income   | \$ 11,049                          | \$ 10,643 |
| Adjustments to reconcile net income to net cash from operating activities: |                                    |           |
| Provision for loan losses  | 366                                | 188       |
| Depreciation and amortization  | 985                                | 1,032     |
| Deferred income taxes  | (1,152)                            | (1,445)   |
| Amortization of fees, discounts, and premiums                              | (374)                              | (310)     |
| Origination of loans held for sale   | (45,452)                           | (27,195)  |
| Proceeds from sales of loans held for sale                                 | 46,459                             | 27,086    |
| Gain on sale of loans, net   | (440)                              | (283)     |
| Net gain on sale of real estate owned                                      | (12)                               |           |
| Purchases of investment securities held for trading                        |                                    | (5,041)   |
| Proceeds from sale of investment securities held for trading               |                                    | 5,071     |
| Gain on sale of investment securities held for trading                     |                                    | (30)      |
| Gain on sale of investment securities held to maturity                     | (476)                              | (1,017)   |
| Net loss on disposal of premises and equipment                             | 4                                  |           |
| ESOP expense   | 866                                | 777       |
| Share-based compensation expense   | 2,417                              | 2,002     |
| Increase in accrued interest receivable                                    | (306)                              | (140)     |
| Net increase in bank-owned life insurance                                  | (769)                              | (796)     |
| Net increase in prepaid expenses and other assets                          | (573)                              | (454)     |
| Net increase (decrease) in accounts payable and accrued expenses           | 3,819                              | (2,038)   |
| Net decrease in advance payments by borrowers for taxes and insurance      | (822)                              | (1,407)   |
| Net increase in income taxes receivable                                    | (1,523)                            |           |
| Net increase (decrease) in income taxes payable                            | 650                                | (48)      |
| Net cash from operating activities   | 14,716                             | 6,595     |
| <b>Cash flows from investing activities:</b>                               |                                    |           |
| Purchases of investment securities held to maturity                        | (10,300)                           | (34,831)  |
| Principal repayments on investment securities held to maturity             | 69,966                             | 48,705    |
| Proceeds from sale of investment securities held to maturity               | 5,083                              | 11,506    |
| Loan originations, net of principal repayments on loans receivable         | (194,900)                          | (68,694)  |
| Purchases of Federal Home Loan Bank stock                                  | (2,920)                            |           |
| Proceeds from redemption of Federal Home Loan Bank stock                   | 9,564                              | 337       |
| Purchases of Federal Reserve Bank stock                                    | (64)                               | (2,904)   |
| Proceeds from sale of real estate owned                                    | 204                                |           |
| Purchases of premises and equipment  | (416)                              | (820)     |
| Net cash from investing activities   | (123,783)                          | (46,701)  |

(Continued)



Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Unaudited)**

(Dollars in thousands)

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2015                               | 2014      |
| <b>Cash flows from financing activities:</b>                           |                                    |           |
| Net increase in deposits   | \$ 53,318                          | \$ 38,545 |
| Proceeds from advances from the Federal Home Loan Bank                 | 115,000                            |           |
| Repayments of advances from the Federal Home Loan Bank                 | (66,000)                           |           |
| Proceeds from securities sold under agreements to repurchase           | 30,000                             |           |
| Repayments of securities sold under agreements to repurchase           | (47,000)                           |           |
| Purchases of Fed Funds   | 10                                 | 10        |
| Sales of Fed Funds   | (10)                               | (10)      |
| Proceeds from issuance of common stock                                 | 17                                 |           |
| Repurchases of common stock  | (7,309)                            | (4,907)   |
| Cash dividends paid  | (4,553)                            | (4,174)   |
| Net cash from financing activities                                     | 73,473                             | 29,464    |
| Net decrease in cash and cash equivalents                              | (35,594)                           | (10,642)  |
| Cash and cash equivalents at beginning of the period                   | 75,060                             | 75,365    |
| Cash and cash equivalents at end of the period                         | \$ 39,466                          | \$ 64,723 |
| Supplemental disclosure of cash flow information:                      |                                    |           |
| Cash paid for:   |                                    |           |
| Interest on deposits and borrowings                                    | \$ 4,780                           | \$ 4,502  |
| Income taxes   | 8,932                              | 7,972     |
| Supplemental disclosure of noncash investing and financing activities: |                                    |           |
| Loans transferred to real estate owned                                 | \$ 192                             | \$        |

See accompanying notes to consolidated financial statements.

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**TERRITORIAL BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**(1) Basis of Presentation**

The accompanying unaudited consolidated financial statements of Territorial Bancorp Inc. (the Company) have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. These interim condensed consolidated financial statements and notes should be read in conjunction with the Company's consolidated financial statements and notes thereto filed as part of the Annual Report on Form 10-K for the year ended December 31, 2014. In the opinion of management, all adjustments necessary for a fair presentation have been made and consist only of normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year.

**(2) Organization**

On November 4, 2008, the Board of Directors of Territorial Mutual Holding Company (MHC) approved a plan of conversion and reorganization under which the MHC would convert from a mutual holding company to a stock holding company. The conversion to a stock holding company was approved by the depositors and borrowers of Territorial Savings Bank and the Office of Thrift Supervision (OTS) and included the filing of a registration statement with the U.S. Securities and Exchange Commission. Upon the completion of the conversion and reorganization on July 10, 2009, Territorial Mutual Holding Company and Territorial Savings Group, Inc. ceased to exist as separate legal entities and Territorial Bancorp Inc. became the holding company for Territorial Savings Bank.

Upon completion of the conversion and reorganization, a special liquidation account was established in an amount equal to the total equity of Territorial Mutual Holding Company as of December 31, 2008. The liquidation account is to provide eligible account holders and supplemental eligible account holders who maintain their deposit accounts with Territorial Savings Bank after the conversion with a liquidation interest in the unlikely event of the complete liquidation of Territorial Savings Bank after the conversion. The balance of the liquidation account at December 31, 2014 was \$15.2 million.

On June 25, 2014, Territorial Savings Bank converted from a federal savings bank to a Hawaii state-chartered savings bank. On July 10, 2014, Territorial Savings Bank became a member of the Federal Reserve System.

**(3) Recently Adopted Accounting Pronouncements**

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In January 2014, the Financial Accounting Standards Board (FASB) amended the Receivables topic of the FASB Accounting Standards Codification (ASC). The amendment clarifies when an in substance repossession or foreclosure occurs and when a mortgage loan should be derecognized and the related real property recognized. The amendment also requires disclosures about the amount of foreclosed residential real property held and the recorded investment in mortgage loans collateralized by residential real property in the process of foreclosure. The amendment was effective for interim and annual periods beginning after December 15, 2014. The Company adopted this amendment on January 1, 2015, and the adoption did not have a material effect on its consolidated financial statements.

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In May 2014, the FASB amended the Revenue Recognition topic of the FASB ASC. The amendment seeks to clarify the principles for recognizing revenue as well as to develop common revenue standards for U.S. generally accepted accounting principles and International Financial Reporting Standards. The amendment is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. In August 2015, the FASB deferred the effective date of the amendment by one year. However, entities may still choose to adopt the amendment as of the original effective date. The Company does not expect the adoption of this amendment to have a material effect on its consolidated financial statements.

In June 2014, the FASB amended the Transfers and Servicing topic of the FASB ASC. The amendment modifies the accounting for certain types of repurchase transactions as well as adds new disclosure requirements for repurchase transactions. The amendment was effective for interim and annual periods beginning after December 15, 2014, with early adoption prohibited. The Company adopted this amendment on January 1, 2015, and the adoption did not have a material effect on its consolidated financial statements. See note 9, Securities Sold Under Agreements to Repurchase.

In August 2014, the FASB amended the Receivables topic of the FASB ASC. The amendment seeks to clarify the classification of foreclosed mortgage loans that are either fully or partially guaranteed under government programs, such as from the Federal Housing Administration (FHA) or the U.S. Department of Veterans Affairs (VA). The amendment was effective for interim and annual periods beginning after December 15, 2014. The Company adopted this amendment on January 1, 2015, and the adoption did not have any effect on its consolidated financial statements.

In April 2015, the FASB amended the Intangibles – Goodwill and Other topic of the FASB ASC. The amendment adds guidance to help entities evaluate the accounting for fees paid in cloud computing arrangements. The amendment is effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. The Company does not expect the adoption of this amendment to have a material effect on its consolidated financial statements.

#### **(4) Cash and Cash Equivalents**

The table below presents the balances of cash and cash equivalents:

| <b>(Dollars in thousands)</b>            | <b>September 30,<br/>2015</b> | <b>December 31,<br/>2014</b> |
|--|-------------------------------|------------------------------|
| Cash and due from banks                  | \$ 9,841                      | \$ 10,803                    |
| Interest-earning deposits in other banks | 29,625                        | 64,257                       |
| Cash and cash equivalents                | \$ 39,466                     | \$ 75,060                    |

Interest-earning deposits in other banks consist primarily of deposits at the Federal Reserve Bank.





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(5) **Investment Securities**

The amortized cost and fair values of investment securities are as follows:

| (Dollars in thousands)                               | Amortized<br>Cost |           | Gains         |           | Gross Unrealized<br>Losses |           | Estimated<br>Fair Value |
|--|-------------------|-----------|---------------|-----------|----------------------------|-----------|-------------------------|
| <b>September 30, 2015:</b>                           |                   |           |               |           |                            |           |                         |
| Held to maturity:                                    |                   |           |               |           |                            |           |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 507,891        | \$        | 15,266        | \$        | (3,479)                    | \$        | 519,678                 |
| Trust preferred securities                           | 856               |           |               |           |                            |           | 856                     |
| <b>Total</b>   | <b>\$ 508,747</b> | <b>\$</b> | <b>15,266</b> | <b>\$</b> | <b>(3,479)</b>             | <b>\$</b> | <b>520,534</b>          |
| <b>December 31, 2014:</b>                            |                   |           |               |           |                            |           |                         |
| Held to maturity:                                    |                   |           |               |           |                            |           |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 572,232        | \$        | 18,078        | \$        | (4,290)                    | \$        | 586,020                 |
| Trust preferred securities                           | 690               |           |               |           |                            |           | 690                     |
| <b>Total</b>   | <b>\$ 572,922</b> | <b>\$</b> | <b>18,078</b> | <b>\$</b> | <b>(4,290)</b>             | <b>\$</b> | <b>586,710</b>          |

The amortized cost and estimated fair value of investment securities at September 30, 2015 are shown below. Incorporated in the maturity schedule are mortgage-backed and trust preferred securities, which are allocated using the contractual maturity as a basis. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands)             | Amortized<br>Cost |           | Estimated<br>Fair Value |
|------------------------------------|-------------------|-----------|-------------------------|
| Held to maturity:                  |                   |           |                         |
| Due within 5 years                 | \$ 37             | \$        | 39                      |
| Due after 5 years through 10 years | 7                 |           | 8                       |
| Due after 10 years                 | 508,703           |           | 520,487                 |
| <b>Total</b>                       | <b>\$ 508,747</b> | <b>\$</b> | <b>520,534</b>          |

Realized gains and losses and the proceeds from sales of securities held to maturity and trading are shown in the table below. All sales of securities were U.S. government-sponsored mortgage-backed securities.

| (Dollars in thousands) | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                        | 2015                                | 2014     | 2015                               | 2014      |
| Proceeds from sales    | \$                                  | \$ 4,307 | \$ 5,083                           | \$ 16,577 |
| Gross gains            |                                     | 392      | 476                                | 1,047     |
| Gross losses           |                                     |          |                                    |           |



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The Company did not sell any held-to-maturity mortgage-backed securities during the three months ended September 30, 2015. During the three months ended September 30, 2014, the Company received proceeds of \$4.3 million from the sale of \$3.9 million of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$392,000. During the nine months ended September 30, 2015 and 2014, the Company received proceeds of \$5.0 million and \$11.5 million, respectively, from the sale of \$4.6 million and \$10.5 million, respectively, of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$415,000 and \$1.0 million, respectively. The sale of these mortgage-backed securities, for which the Company had already collected a substantial portion of the original purchased principal (at least 85%), is in accordance with the Investments – Debt and Equity Securities topic of the FASB ASC and does not taint management’s assertion of intent to hold remaining securities in the held-to-maturity portfolio to maturity.

During the nine months ended September 30, 2015, the Company received proceeds of \$61,000 from the sale of one of the trust preferred securities the Company owned, PreTSL XXIV. The Company previously wrote off the entire book value of this security when it incurred an other-than-temporary impairment charge in prior years. The trust preferred security sold was classified in the held-to-maturity portfolio. Since the credit rating of this security was downgraded, in accordance with the Investments – Debt and Equity Securities topic of the FASB ASC, the sale of this security does not taint management’s assertion of intent to hold remaining securities in the held-to-maturity portfolio to maturity.

During the nine months ended September 30, 2014, the Company received proceeds of \$5.0 million from the sale of a held-for-trading security and recognized a gain of \$30,000.

Investment securities with amortized costs of \$246.5 million and \$270.2 million at September 30, 2015 and December 31, 2014, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase and transaction clearing accounts.

Provided below is a summary of investment securities which were in an unrealized loss position at September 30, 2015 and December 31, 2014. The Company does not intend to sell these securities until such time as the value recovers or the securities mature and it is not more likely than not that the Company will be required to sell the securities prior to recovery of value or the securities mature.

| Description of Securities<br>(Dollars in thousands) | Less Than 12 Months |                      | 12 Months or Longer |                      | Number of<br>Securities | Total      |                      |  |
|---|---------------------|----------------------|---------------------|----------------------|-------------------------|------------|----------------------|--|
|   | Fair Value          | Unrealized<br>Losses | Fair Value          | Unrealized<br>Losses |                         | Fair Value | Unrealized<br>Losses |  |
| September 30, 2015:                                 |                     |                      |                     |                      |                         |            |                      |  |
| Mortgage-backed securities                          | \$ 126,413          | \$ 1,976             | \$ 54,029           | \$ 1,503             | 34                      | \$ 180,442 | \$ 3,479             |  |
| December 31, 2014:                                  |                     |                      |                     |                      |                         |            |                      |  |
| Mortgage-backed securities                          | \$ 12,717           | \$ 65                | \$ 183,349          | \$ 4,225             | 37                      | \$ 196,066 | \$ 4,290             |  |

**Mortgage-Backed Securities.** The unrealized losses on the Company’s investment in mortgage-backed securities were caused by increases in market interest rates. All of the mortgage-backed securities are guaranteed by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. Since the decline in market value is attributable to changes in interest rates and not credit quality, and the Company does not intend to sell these investments until maturity and it is not more likely than not that the Company will be required to sell such investments prior to recovery of its cost basis, the Company does not consider these investments



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to be other-than-temporarily impaired as of September 30, 2015 and December 31, 2014.

**Trust Preferred Securities.** At September 30, 2015, the Company owned one trust preferred security, PreTSL XXIII. The trust preferred security represents an investment in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. This security is classified in the Company's held-to-maturity investment portfolio.

The trust preferred securities market is considered to be inactive as only six transactions have occurred over the past 45 months in the same tranche of securities owned by the Company. The Company uses a discounted cash flow model to determine whether this security is other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows.

Based on the Company's review, the Company's investment in PreTSL XXIII did not incur additional impairment during the quarter ended September 30, 2015.

PreTSL XXIII has an amortized cost of \$856,000 at September 30, 2015. The difference between the amortized cost of \$856,000 and the remaining cost basis of \$1.1 million is reported as accumulated other comprehensive loss and is related to noncredit factors.

It is reasonably possible that the fair value of the trust preferred security could decline in the near term if the overall economy and the financial condition of some of the issuers continue to deteriorate and the liquidity of this security remains low. As a result, there is a risk that the Company's remaining cost basis of \$1.1 million on its trust preferred security could be credit-related other-than-temporarily impaired in the near term. The impairment, if any, could be material to the Company's consolidated statements of income.

The table below provides a cumulative roll forward of credit losses recognized in earnings for debt securities held and not intended to be sold:

| <b>(Dollars in thousands)</b>  | <b>2015</b> |         | <b>2014</b> |       |
|--|-------------|---------|-------------|-------|
| Balance at January 1,  | \$          | 5,885   | \$          | 5,885 |
| Credit losses on debt securities for which other-than-temporary impairment was not previously recognized |             |         |             |       |
| Credit losses on debt securities which were sold   |             | (3,482) |             |       |
| Balance at September 30,   | \$          | 2,403   | \$          | 5,885 |

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The table below shows the components of accumulated other comprehensive loss, net of taxes, resulting from other-than-temporarily impaired securities:

| (Dollars in thousands)   |      | September 30, |      | 2014 |
|--|------|---------------|------|------|
|  | 2015 |               | 2014 |      |
| Noncredit losses on other-than-temporarily impaired securities, net of taxes | \$   | 183           | \$   | 301  |

**(6) Loans Receivable and Allowance for Loan Losses**

The components of loans receivable are as follows:

| (Dollars in thousands)                                       |    | September 30, |    | December 31, |
|--|----|---------------|----|--------------|
|  |    | 2015          |    | 2014         |
| Real estate loans:   |    |               |    |              |
| First mortgages:   |    |               |    |              |
| One- to four-family residential                              | \$ | 1,123,353     | \$ | 926,074      |
| Multi-family residential                                     |    | 9,910         |    | 8,920        |
| Construction, commercial, and other                          |    | 16,422        |    | 18,415       |
| Home equity loans and lines of credit                        |    | 15,053        |    | 15,992       |
| Total real estate loans                                      |    | 1,164,738     |    | 969,401      |
| Other loans:   |    |               |    |              |
| Loans on deposit accounts                                    |    | 282           |    | 441          |
| Consumer and other loans                                     |    | 4,467         |    | 4,173        |
| Total other loans  |    | 4,749         |    | 4,614        |
| Less:  |    |               |    |              |
| Net unearned fees and discounts                              |    | (4,133)       |    | (4,112)      |
| Allowance for loan losses                                    |    | (2,062)       |    | (1,691)      |
| Total unearned fees, discounts and allowance for loan losses |    | (6,195)       |    | (5,803)      |
| Loans receivable, net  | \$ | 1,163,292     | \$ | 968,212      |

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The table below presents the activity in the allowance for loan losses by portfolio segment:

| (Dollars in thousands)                            | Residential<br>Mortgage | Construction,<br>Commercial<br>and Other<br>Mortgage<br>Loans | Home<br>Equity<br>Loans and<br>Lines of<br>Credit | Consumer<br>and Other | Unallocated | Totals   |
|---|-------------------------|---|---|-----------------------|-------------|----------|
| Three months ended September 30, 2015:            |                         |   |   |                       |             |          |
| Balance, beginning of period                      | \$ 1,243                | \$ 407  | \$ 3  | \$ 101                | \$ 240      | \$ 1,994 |
| Provision (reversal of allowance) for loan losses | 109                     |   |   | (20)                  | (18)        | 71       |
|   | 1,352                   | 407   | 3   | 81                    | 222         | 2,065    |
| Charge-offs                                       |                         |   |   | (10)                  |             | (10)     |
| Recoveries  |                         | 3   | 1   | 3                     |             | 7        |
| Net charge-offs                                   |                         | 3   | 1   | (7)                   |             | (3)      |
| Balance, end of period                            | \$ 1,352                | \$ 410  | \$ 4  | \$ 74                 | \$ 222      | \$ 2,062 |
| Nine months ended September 30, 2015:             |                         |   |   |                       |             |          |
| Balance, beginning of period                      | \$ 413                  | \$ 977  | \$ 5  | \$ 263                | \$ 33       | \$ 1,691 |
| Provision (reversal of allowance) for loan losses | 936                     | (577)   | (18)  | (164)                 | 189         | 366      |
|   | 1,349                   | 400   | (13)  | 99                    | 222         | 2,057    |
| Charge-offs                                       |                         |   |   | (35)                  |             | (35)     |
| Recoveries  | 3                       | 10  | 17  | 10                    |             | 40       |
| Net charge-offs                                   | 3                       | 10  | 17  | (25)                  |             | 5        |
| Balance, end of period                            | \$ 1,352                | \$ 410  | \$ 4  | \$ 74                 | \$ 222      | \$ 2,062 |

| (Dollars in thousands)                            | Residential<br>Mortgage | Construction,<br>Commercial<br>and Other<br>Mortgage<br>Loans | Home<br>Equity<br>Loans and<br>Lines of<br>Credit | Consumer<br>and Other | Unallocated | Totals   |
|---|-------------------------|---|---|-----------------------|-------------|----------|
| Three months ended September 30, 2014:            |                         |   |   |                       |             |          |
| Balance, beginning of period                      | \$ 344                  | \$ 932  | \$ 7  | \$ 159                | \$ 68       | \$ 1,510 |
| Provision (reversal of allowance) for loan losses | 9                       | 78  | (1)   | (5)                   | (58)        | 23       |
|   | 353                     | 1,010   | 6   | 154                   | 10          | 1,533    |
| Charge-offs                                       |                         |   |   | (10)                  |             | (10)     |
| Recoveries  |                         | 1   | 1   | 3                     |             | 5        |
| Net charge-offs                                   |                         | 1   | 1   | (7)                   |             | (5)      |
| Balance, end of period                            | \$ 353                  | \$ 1,011  | \$ 7  | \$ 147                | \$ 10       | \$ 1,528 |
| Nine months ended September 30, 2014:             |                         |   |   |                       |             |          |
| Balance, beginning of period                      | \$ 376                  | \$ 799  | \$ 10   | \$ 229                | \$ 72       | \$ 1,486 |
| Provision (reversal of allowance) for loan losses | 95                      | 211   | 4   | (60)                  | (62)        | 188      |
|   | 471                     | 1,010   | 14  | 169                   | 10          | 1,674    |
| Charge-offs                                       | (118)                   |   | (10)  | (35)                  |             | (163)    |
| Recoveries  |                         | 1   | 3   | 13                    |             | 17       |
| Net charge-offs                                   | (118)                   | 1   | (7)   | (22)                  |             | (146)    |
| Balance, end of period                            | \$ 353                  | \$ 1,011  | \$ 7  | \$ 147                | \$ 10       | \$ 1,528 |





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During the nine months ended September 30, 2015, the Company increased the loan loss provisions for residential mortgage loans based on the growth of this segment of the loan portfolio and the concentration of loans in Hawaii. The Company also reduced the loan loss provisions on construction, commercial and other mortgage loans, home equity loans and lines of credit and consumer and other loans based on a continued limited loss experience. The allocation of a portion of the allowance from one category of loans does not preclude its availability to absorb losses in other loan categories.

Management considers the allowance for loan losses at September 30, 2015 to be at an appropriate level to provide for probable losses that can be reasonably estimated based on general and specific conditions at that date. While the Company uses the best information it has available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. To the extent actual outcomes differ from the estimates, additional provisions for credit losses may be required that would reduce future earnings. In addition, as an integral part of their examination process, the bank regulators periodically review the allowance for loan losses and may require the Company to increase the allowance based on their analysis of information available at the time of their examination.

The table below presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method:

| (Dollars in thousands)                | Residential<br>Mortgage | Construction,<br>Commercial<br>and Other<br>Mortgage<br>Loans | Home<br>Equity<br>Loans and<br>Lines of<br>Credit | Consumer<br>and Other | Unallocated   | Totals              |
|---------------------------------------|-------------------------|---|---|-----------------------|---------------|---------------------|
| <b>September 30, 2015:</b>            |                         |   |   |                       |               |                     |
| Allowance for loan losses:            |                         |   |   |                       |               |                     |
| Ending allowance balance:             |                         |   |   |                       |               |                     |
| Individually evaluated for impairment | \$                      | \$  | \$  | \$                    | \$            | \$                  |
| Collectively evaluated for impairment | 1,352                   | 410   | 4   | 74                    | 222           | 2,062               |
| <b>Total ending allowance balance</b> | <b>\$ 1,352</b>         | <b>\$ 410</b>   | <b>\$ 4</b>                                       | <b>\$ 74</b>          | <b>\$ 222</b> | <b>\$ 2,062</b>     |
| <b>Loans:</b>                         |                         |   |   |                       |               |                     |
| Ending loan balance:                  |                         |   |   |                       |               |                     |
| Individually evaluated for impairment | \$ 6,473                | \$  | \$ 124  | \$                    | \$            | \$ 6,597            |
| Collectively evaluated for impairment | 1,122,709               | 16,349  | 14,937  | 4,762                 |               | 1,158,757           |
| <b>Total ending loan balance</b>      | <b>\$ 1,129,182</b>     | <b>\$ 16,349</b>  | <b>\$ 15,061</b>                                  | <b>\$ 4,762</b>       | <b>\$</b>     | <b>\$ 1,165,354</b> |
| <b>December 31, 2014:</b>             |                         |   |   |                       |               |                     |
| Allowance for loan losses:            |                         |   |   |                       |               |                     |
| Ending allowance balance:             |                         |   |   |                       |               |                     |
| Individually evaluated for impairment | \$                      | \$  | \$  | \$                    | \$            | \$                  |
| Collectively evaluated for impairment | 413                     | 977   | 5   | 263                   | 33            | 1,691               |
| <b>Total ending allowance balance</b> | <b>\$ 413</b>           | <b>\$ 977</b>   | <b>\$ 5</b>                                       | <b>\$ 263</b>         | <b>\$ 33</b>  | <b>\$ 1,691</b>     |
| <b>Loans:</b>                         |                         |   |   |                       |               |                     |

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Ending loan balance:

|                                       |    |         |    |        |    |        |    |       |    |         |
|---------------------------------------|----|---------|----|--------|----|--------|----|-------|----|---------|
| Individually evaluated for impairment | \$ | 6,158   | \$ |        | \$ | 296    | \$ | 4     | \$ | 6,458   |
| Collectively evaluated for impairment |    | 924,732 |    | 18,399 |    | 15,702 |    | 4,612 |    | 963,445 |
| Total ending loan balance             | \$ | 930,890 | \$ | 18,399 | \$ | 15,998 | \$ | 4,616 | \$ | 969,903 |

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The table below presents the balance of impaired loans individually evaluated for impairment by class of loans:

| (Dollars in thousands)                    | Recorded<br>Investment | Unpaid<br>Principal<br>Balance |
|---|------------------------|--------------------------------|
| September 30, 2015:                       |                        |                                |
| With no related allowance recorded:       |                        |                                |
| One- to four-family residential mortgages | \$ 6,473               | \$ 7,234                       |
| Home equity loans and lines of credit     | 124                    | 160                            |
| <b>Total</b>                              | <b>\$ 6,597</b>        | <b>\$ 7,394</b>                |
| December 31, 2014:                        |                        |                                |
| With no related allowance recorded:       |                        |                                |
| One- to four-family residential mortgages | \$ 6,158               | \$ 6,775                       |
| Home equity loans and lines of credit     | 296                    | 324                            |
| Consumer and other                        | 4                      | 4                              |
| <b>Total</b>                              | <b>\$ 6,458</b>        | <b>\$ 7,103</b>                |

The table below presents the average recorded investment and interest income recognized on impaired loans by class of loans:

| (Dollars in thousands)                    | For the Three Months Ended<br>September 30, |                                  | For the Nine Months Ended<br>September 30, |                                  |
|---|---|----------------------------------|--|----------------------------------|
|   | Average<br>Recorded<br>Investment           | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment          | Interest<br>Income<br>Recognized |
| 2015:                                     |   |                                  |  |                                  |
| With no related allowance recorded:       |   |                                  |  |                                  |
| One- to four-family residential mortgages | \$ 6,515                                    | \$ 16                            | \$ 6,586                                   | \$ 52                            |
| Home equity loans and lines of credit     | 126   |                                  | 129  |                                  |
| <b>Total</b>                              | <b>\$ 6,641</b>                             | <b>\$ 16</b>                     | <b>\$ 6,715</b>                            | <b>\$ 52</b>                     |
| 2014:                                     |   |                                  |  |                                  |
| With no related allowance recorded:       |   |                                  |  |                                  |
| One- to four-family residential mortgages | \$ 6,785                                    | \$ 28                            | \$ 6,931                                   | \$ 88                            |
| Home equity loans and lines of credit     | 302   |                                  | 311  |                                  |
| Consumer and other                        | 1   |                                  | 1  |                                  |
| <b>Total</b>                              | <b>\$ 7,088</b>                             | <b>\$ 28</b>                     | <b>\$ 7,243</b>                            | <b>\$ 88</b>                     |

There were no loans individually evaluated for impairment with a related allowance for loan loss as of September 30, 2015 or December 31, 2014. Loans individually evaluated for impairment do not have an allocated allowance for loan loss because they are written down to fair value.

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The table below presents the aging of loans and accrual status by class of loans:

| (Dollars in thousands)                       | 30 Days Past Due | 59 Days Past Due | 60 Days Past Due | 89 Days Past Due | 90 Days or Greater Past Due | Total Past Due  | Loans Not Past Due  | Total Loans         | Nonaccrual Loans | Loans More Than 90 Days Past Due and Still Accruing |
|--|------------------|------------------|------------------|------------------|-----------------------------|-----------------|---------------------|---------------------|------------------|---|
| September 30, 2015:                          |                  |                  |                  |                  |                             |                 |                     |                     |                  |   |
| One- to four-family residential mortgages    | \$ 1,511         |                  |                  |                  | \$ 1,516                    | \$ 3,027        | \$ 1,116,270        | \$ 1,119,297        | \$ 5,265         | \$  |
| Multi-family residential mortgages           |                  |                  |                  |                  |                             |                 | 9,885               | 9,885               |                  |   |
| Construction, commercial and other mortgages |                  |                  |                  |                  |                             |                 | 16,349              | 16,349              |                  |   |
| Home equity loans and lines of credit        |                  |                  |                  |                  |                             |                 | 15,061              | 15,061              | 124              |   |
| Loans on deposit accounts                    |                  |                  |                  |                  |                             |                 | 282                 | 282                 |                  |   |
| Consumer and other                           | 6                |                  | 1                |                  |                             | 7               | 4,473               | 4,480               |                  |   |
| <b>Total</b>                                 | <b>\$ 1,517</b>  | <b>\$</b>        | <b>1</b>         | <b>\$</b>        | <b>1,516</b>                | <b>\$ 3,034</b> | <b>\$ 1,162,320</b> | <b>\$ 1,165,354</b> | <b>\$ 5,389</b>  | <b>\$</b>   |
| December 31, 2014:                           |                  |                  |                  |                  |                             |                 |                     |                     |                  |   |
| One- to four-family residential mortgages    | \$ 1,040         |                  | 736              |                  | 593                         | 2,369           | 919,624             | 921,993             | 4,153            | \$  |
| Multi-family residential mortgages           |                  |                  |                  |                  |                             |                 | 8,897               | 8,897               |                  |   |
| Construction, commercial and other mortgages |                  |                  |                  |                  |                             |                 | 18,399              | 18,399              |                  |   |
| Home equity loans and lines of credit        |                  |                  |                  |                  | 161                         | 161             | 15,837              | 15,998              | 296              |   |
| Loans on deposit accounts                    |                  |                  |                  |                  |                             |                 | 440                 | 440                 |                  |   |
| Consumer and other                           | 7                |                  | 1                |                  | 4                           | 12              | 4,164               | 4,176               | 4                |   |
| <b>Total</b>                                 | <b>\$ 1,047</b>  | <b>\$</b>        | <b>737</b>       | <b>\$</b>        | <b>758</b>                  | <b>\$ 2,542</b> | <b>\$ 967,361</b>   | <b>\$ 969,903</b>   | <b>\$ 4,453</b>  | <b>\$</b>   |

The Company primarily uses the aging of loans and accrual status to monitor the credit quality of its loan portfolio. When a mortgage loan becomes seriously delinquent (90 days or more contractually past due), it displays weaknesses that may result in a loss. As a loan becomes more delinquent, the likelihood of the borrower repaying the loan decreases and the loan becomes more collateral-dependent. A mortgage loan becomes collateral-dependent when the proceeds for repayment can be expected to come only from the sale or operation of the collateral and not from borrower repayments. Generally, appraisals are obtained after a loan becomes collateral-dependent or is five months delinquent. The carrying value of collateral-dependent loans is adjusted to the fair value of the collateral less selling costs. Any commercial real estate, commercial, construction or equity loan that has a loan balance in excess of a specified amount is also periodically reviewed to determine whether the loan exhibits any weaknesses and is performing in accordance with its contractual terms.

The Company had 20 nonaccrual loans with a book value of \$5.4 million at September 30, 2015 and 18 nonaccrual loans with a book value of \$4.5 million as of December 31, 2014. The Company collected interest on nonaccrual loans of \$170,000 and \$197,000 during the nine months ended September 30, 2015 and 2014, respectively, but due to regulatory requirements, the Company recorded



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the interest as a reduction of principal. The Company would have recognized additional interest income of \$231,000 and \$164,000 during the nine months ended September 30, 2015 and 2014, respectively, had the loans been accruing interest. The Company did not have any loans more than 90 days past due and still accruing interest as of September 30, 2015 and December 31, 2014.

There were no loans modified in a troubled debt restructuring during the nine months ended September 30, 2015 or 2014. There were no new troubled debt restructurings within the past 12 months that subsequently defaulted.

The Company had 15 troubled debt restructurings totaling \$3.4 million as of September 30, 2015 that were considered to be impaired. This total included 14 one- to four-family residential mortgage loans totaling \$3.3 million and one home equity loan for \$124,000. Four of the loans, totaling \$889,000, are performing in accordance with their restructured terms and accruing interest at September 30, 2015. One of the loans, for \$319,000, was 59 days delinquent and accruing interest at September 30, 2015. Nine of the loans, totaling \$2.1 million, are performing in accordance with their restructured terms but not accruing interest at September 30, 2015. One of the loans, for \$149,000, was more than 149 days delinquent and not accruing interest as of September 30, 2015. The Company had 17 troubled debt restructurings totaling \$4.6 million as of December 31, 2014 that were considered to be impaired. This total included 16 one- to four-family residential mortgage loans totaling \$4.4 million and one home equity loan for \$135,000. Six of the loans, totaling \$2.0 million, were performing in accordance with their restructured terms and accruing interest at December 31, 2014. Nine of the loans, totaling \$2.2 million, were performing in accordance with their restructured terms but not accruing interest at December 31, 2014. Two of the loans, totaling \$343,000, were delinquent and not accruing interest at December 31, 2014. Restructurings include deferrals of interest and/or principal payments and temporary or permanent reductions in interest rates due to the financial difficulties of the borrowers. At September 30, 2015, we had no commitments to lend any additional funds to these borrowers.

The Company had no real estate owned as of September 30, 2015 or December 31, 2014. There were three one-to four-family residential mortgage loans totaling \$685,000 in the process of foreclosure as of September 30, 2015, and two one- to four-family residential mortgage loans totaling \$352,000 in the process of foreclosure as of September 30, 2014.

Nearly all of our real estate loans are collateralized by real estate located in the State of Hawaii. Loan-to-value ratios on these real estate loans generally do not exceed 80% at the time of origination.

During the nine months ended September 30, 2015 and 2014, the Company sold \$46.2 million and \$26.9 million, respectively, of mortgage loans held for sale and recognized gains of \$440,000 and \$283,000, respectively. During the three months ended September 30, 2015 and 2014, the Company sold \$17.7 million and \$10.0 million, respectively, of mortgage loans held for sale and recognized gains of \$201,000 and \$118,000, respectively. The Company had one loan held for sale for \$225,000 at September 30, 2015 and six loans held for sale totaling \$1.0 million at December 31, 2014.

The Company serviced loans for others of \$53.4 million at September 30, 2015 and \$60.5 million at December 31, 2014. Of these amounts, \$2.8 million and \$3.0 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at September 30, 2015 and December 31, 2014, respectively. The amount of contractually specified servicing fees earned for the nine-month periods ended September 30, 2015 and 2014 was \$117,000 and \$137,000, respectively. The amount of contractually specified servicing fees earned for the three-month periods ended September 30, 2015 and 2014 was \$37,000 and \$44,000, respectively. The fees are reported in service fees on loan and deposit accounts in the consolidated statements of income.





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On June 1, 2015, the Federal Home Loan Bank of Seattle (FHLB Seattle) completed its merger with the Federal Home Loan Bank of Des Moines (FHLB Des Moines). After the merger, the FHLB Des Moines repurchased all outstanding excess capital stock, resulting in the repurchase of \$7.2 million of capital stock we held in the FHLB Des Moines. Combined with \$559,000 of additional net stock purchases related to collateral on new advances, this resulted in a decrease in our investment in FHLB stock from \$11.2 million at December 31, 2014 to \$4.6 million at September 30, 2015.

**(8) Advances from the Federal Home Loan Bank**

Federal Home Loan Bank advances are secured by a blanket pledge on the Bank's assets not otherwise pledged. Our credit line with the FHLB Seattle was equal to 25% of Territorial Savings Bank's total assets and as of December 31, 2014, we had the capacity to borrow an additional \$399.0 million. After the FHLB Seattle merged with the FHLB Des Moines, our credit line was raised to 35% of Territorial Savings Bank's total assets and as of September 30, 2015, we had the capacity to borrow an additional \$546.0 million.

Advances outstanding consisted of the following:

| (Dollars in thousands)      | September 30, 2015 |                       | December 31, 2014 |                       |
|-----------------------------|--------------------|-----------------------|-------------------|-----------------------|
|                             | Amount             | Weighted Average Rate | Amount            | Weighted Average Rate |
| Due within one year         | \$                 | %                     | \$ 10,000         | 2.06%                 |
| Due over 2 years to 3 years | 27,000             | 1.33                  |                   |                       |
| Due over 3 years to 4 years | 27,000             | 1.63                  | 5,000             | 1.20                  |
| Due over 4 years to 5 years | 10,000             | 1.66                  |                   |                       |
| Total                       | \$ 64,000          | 1.51%                 | \$ 15,000         | 1.77%                 |

**(9) Securities Sold Under Agreements to Repurchase**

Securities sold under agreements to repurchase are treated as financings and the obligations to repurchase the identical securities sold are reflected as a liability with the securities collateralizing the agreements classified as an asset. Securities sold under agreements to repurchase are summarized as follows:

| (Dollars in thousands) | September 30, 2015   |                       | December 31, 2014    |                       |
|------------------------|----------------------|-----------------------|----------------------|-----------------------|
|                        | Repurchase Liability | Weighted Average Rate | Repurchase Liability | Weighted Average Rate |
|                        |                      |                       |                      |                       |

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| Maturing:               |    |        |       |    |              |
|-------------------------|----|--------|-------|----|--------------|
| 1 year or less          | \$ |        | %     | \$ | 47,000 2.11% |
| Over 2 years to 3 years |    | 25,000 | 1.46  |    | 25,000 1.46  |
| Over 3 years to 4 years |    | 20,000 | 1.66  |    |              |
| Over 4 years to 5 years |    | 10,000 | 1.65  |    |              |
| Total                   | \$ | 55,000 | 1.57% | \$ | 72,000 1.88% |

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Below is a summary comparing the carrying value and fair value of securities pledged to secure repurchase agreements, the repurchase liability, and the amount at risk at September 30, 2015. The amount at risk is the greater of the carrying value or fair value over the repurchase liability and refers to the potential loss to the Company if the secured lender fails to return the security at the maturity date of the agreement. All the agreements to repurchase are with JP Morgan Securities and the securities pledged are mortgage-backed securities issued and guaranteed by U.S. government-sponsored enterprises. The repurchase liability cannot exceed 90% of the fair value of securities pledged. In the event of a decline in the fair value of securities pledged to less than the required amount due to market conditions or principal repayments, the Company is obligated to pledge additional securities or other suitable collateral to cure the deficiency.

| (Dollars in thousands) | Carrying<br>Value of<br>Securities | Fair<br>Value of<br>Securities | Repurchase<br>Liability | Amount<br>at Risk | Weighted<br>Average<br>Months to<br>Maturity |
|------------------------|------------------------------------|--------------------------------|-------------------------|-------------------|--|
| <b>Maturing:</b>       |                                    |                                |                         |                   |  |
| Over 90 days           | \$ 68,552                          | \$ 69,459                      | \$ 55,000               | \$ 14,459         | 35   |

### **(10) Offsetting of Financial Liabilities**

Securities sold under agreements to repurchase are subject to a right of offset in the event of default. See note 9, Securities Sold Under Agreements to Repurchase, for additional information.

| (Dollars in thousands)                            | Gross Amount<br>of Recognized<br>Liabilities | Gross Amount<br>Offset in the<br>Balance Sheet | Net Amount of<br>Liabilities<br>Presented in the<br>Balance Sheet | Gross Amount Not Offset in the<br>Balance Sheet<br>Financial<br>Instruments | Cash Collateral<br>Pledged | Net Amount |
|---|--|--|---|---|----------------------------|------------|
| <b>September 30, 2015:</b>                        |  |  |   |   |                            |            |
| Securities sold under agreements<br>to repurchase | \$ 55,000                                    | \$   | \$ 55,000   | \$ 55,000   | \$                         | \$         |
| <b>December 31, 2014:</b>                         |  |  |   |   |                            |            |
| Securities sold under agreements<br>to repurchase | \$ 72,000                                    | \$   | \$ 72,000   | \$ 72,000   | \$                         | \$         |

### **(11) Employee Benefit Plans**

The Company has a noncontributory defined benefit pension plan (Pension Plan) that covers most employees with at least one year of service. Effective December 31, 2008, under approved changes to the Pension Plan, there were no further accruals of benefits for any participants and benefits will not increase with any additional years of service. Net periodic benefit cost, subsequent to December 31, 2008, has not been significant and is not disclosed in the table below.

The Company also sponsors a Supplemental Employee Retirement Plan (SERP), a noncontributory supplemental retirement benefit plan, which covers certain current and former employees of the Company for amounts in addition to those provided under the Pension Plan.



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The components of net periodic benefit cost were as follows:

| (Dollars in thousands)                   | SERP<br>Three Months Ended<br>September 30, |       | SERP<br>Nine Months Ended<br>September 30, |        |
|--|---|-------|--|--------|
|  | 2015  | 2014  | 2015                                       | 2014   |
| Net periodic benefit cost for the period |   |       |  |        |
| Service cost                             | \$ 21                                       | \$ 25 | \$ 63                                      | \$ 75  |
| Interest cost                            | 31  | 30    | 93   | 89     |
| Expected return on plan assets           |   |       |  |        |
| Amortization of prior service cost       |   |       |  |        |
| Recognized actuarial loss                |   |       |  |        |
| Recognized curtailment loss              |   |       |  |        |
| Net periodic benefit cost                | \$ 52                                       | \$ 55 | \$ 156                                     | \$ 164 |

**(12) Employee Stock Ownership Plan**

Effective January 1, 2009, Territorial Savings Bank adopted an Employee Stock Ownership Plan (ESOP) for eligible employees. The ESOP borrowed \$9.8 million from the Company and used those funds to acquire 978,650 shares, or 8%, of the total number of shares issued by the Company in its initial public offering. The shares were acquired at a price of \$10.00 per share.

The loan is secured by the shares purchased with the loan proceeds and will be repaid by the ESOP over the 20-year term of the loan with funds from Territorial Savings Bank's contributions to the ESOP and dividends payable on the shares. The interest rate on the ESOP loan is an adjustable rate equal to the prime rate, as published in The Wall Street Journal. The interest rate adjusts annually and will be the prime rate on the first business day of the calendar year.

Shares purchased by the ESOP are held by a trustee in an unallocated suspense account, and shares are released annually from the suspense account on a pro-rata basis as principal and interest payments are made by the ESOP to the Company. The trustee allocates the shares released among participants on the basis of each participant's proportional share of compensation relative to all participants. As shares are committed to be released from the suspense account, Territorial Savings Bank reports compensation expense based on the average fair value of shares released with a corresponding credit to stockholders' equity. The shares committed to be released are considered outstanding for earnings per share computations. Compensation expense recognized for the three months ended September 30, 2015 and 2014 amounted to \$266,000 and \$216,000, respectively. Compensation expense recognized for the nine months ended September 30, 2015 and 2014 amounted to \$729,000 and \$673,000, respectively.

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Shares held by the ESOP trust were as follows:

|   | September 30,<br>2015 | December 31,<br>2014 |
|---|-----------------------|----------------------|
| Allocated shares                            | 314,324               | 283,381              |
| Unearned shares                             | 648,358               | 685,057              |
| Total ESOP shares                           | 962,682               | 968,438              |
| Fair value of unearned shares, in thousands | \$ 16,883             | \$ 14,763            |

The ESOP restoration plan is a nonqualified plan that provides supplemental benefits to certain executives who are prevented from receiving the full benefits contemplated by the ESOP's benefit formula. The supplemental cash payments consist of payments representing shares that cannot be allocated to the participants under the ESOP due to IRS limitations imposed on tax-qualified plans. We accrue for these benefits over the period during which employees provide services to earn these benefits. For the three months ended September 30, 2015 and 2014, we accrued \$91,000 and \$63,000, respectively, for the ESOP restoration plan. For the nine months ended September 30, 2015 and 2014, we accrued \$194,000 and \$156,000, respectively, for the ESOP restoration plan.

**(13) Share-Based Compensation**

On August 19, 2010, Territorial Bancorp Inc. adopted the 2010 Equity Incentive Plan, which provides for awards of stock options and restricted stock to key officers and outside directors. In accordance with the Compensation - Stock Compensation topic of the FASB ASC, the cost of the 2010 Equity Incentive Plan is based on the fair value of the awards on the grant date. The fair value of restricted stock is based on the closing price of the Company's stock on the grant date. The fair value of stock options is estimated using a Black-Scholes option pricing model using assumptions for dividend yield, stock price volatility, risk-free interest rate and option term. These assumptions are based on our judgments regarding future events, are subjective in nature, and cannot be determined with precision. The cost of the awards will be recognized on a straight-line basis over the three-, five- or six-year vesting period during which participants are required to provide services in exchange for the awards.

The Company recognized compensation expense, measured as the fair value of the share-based award on the date of grant, on a straight-line basis over the vesting period. Share-based compensation is recorded in the statement of income as a component of salaries and employee benefits with a corresponding increase in shareholders' equity. The table below presents information on compensation expense and the related tax benefit for all share-based awards:

| (In thousands)       | For the Three Months Ended<br>September 30, |        | For the Nine Months Ended<br>September 30, |          |
|----------------------|---|--------|--|----------|
|                      | 2015  | 2014   | 2015                                       | 2014     |
| Compensation expense | \$ 674                                      | \$ 675 | \$ 2,001                                   | \$ 2,002 |
| Income tax benefit   | 271   | 302    | 803  | 911      |

Shares of our common stock issued under the 2010 Equity Incentive Plan shall be authorized but unissued shares. The maximum number of shares that will be awarded under the plan will be 1,712,637 shares.



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**Stock Options**

The table below presents the stock option activity for the nine months ended September 30, 2015 and 2014:

|  | Options | Weighted<br>Average<br>Exercise<br>Price | Remaining<br>Contractual<br>Life (Years) | Aggregate<br>Intrinsic Value<br>(in Thousands) |
|--|---------|--|--|--|
| Options outstanding at December 31, 2014             | 832,954 | \$ 17.38                                 | 5.68                                     | \$ 3,471                                       |
| Granted  | 3,600   | 26.23                                    | 9.92                                     |  |
| Exercised  | 1,000   | 17.36                                    |  | 8  |
| Forfeited  | 3,254   | 17.36                                    |  |  |
| Expired  |         |  |  |  |
| Options outstanding at September 30, 2015            | 832,300 | \$ 17.42                                 | 4.95                                     | \$ 7,173                                       |
| Options outstanding at December 31, 2013             | 832,954 | \$ 17.38                                 | 6.68                                     | \$ 4,845                                       |
| Granted  |         |  |  |  |
| Exercised  |         |  |  |  |
| Forfeited  |         |  |  |  |
| Expired  |         |  |  |  |
| Options outstanding at September 30, 2014            | 832,954 | \$ 17.38                                 | 5.93                                     | \$ 2,421                                       |
| Options vested and exercisable at September 30, 2015 | 693,026 | \$ 17.38                                 | 4.93                                     | \$ 6,000                                       |

There were 1,000 stock options exercised during the three and nine months ended September 30, 2015. There were no stock options exercised during the three and nine months ended September 30, 2014.

The following summarizes certain stock option activity of the Company:

| (In thousands)                                     | For the Three Months Ended<br>September 30, |       | For the Nine Months Ended<br>September 30, |       |
|--|---|-------|--|-------|
|  | 2015  | 2014  | 2015                                       | 2014  |
| Intrinsic value of stock options exercised         | \$ 8  | \$    | \$ 8                                       | \$    |
| Cash received from stock options exercised         | 17  |       | 17   |       |
| Tax benefits realized from stock options exercised | 3   |       | 3  |       |
| Total fair value of stock options that vested      | 3,618                                       | 2,819 | 3,618                                      | 2,819 |

As of September 30, 2015, the Company had \$651,000 of unrecognized compensation costs related to the stock option plan. The cost of the stock option plan is being amortized over the three-, five- or six-year vesting period.



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There were 3,600 options granted in the three and nine months ended September 30, 2015. There were no options granted in the three or nine months ended September 30, 2014.

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The fair value of the Company's stock options was determined using the Black-Scholes option pricing formula. The following assumptions were used in the formula for options issued in 2015:

|                                   | 2015     |
|-----------------------------------|----------|
| Expected volatility               | 20.56%   |
| Risk-free interest rate           | 1.62%    |
| Expected dividends                | 2.59%    |
| Expected life (in years)          | 6.00     |
| Grant price for the stock options | \$ 26.23 |

*Expected volatility* - Based on the historical volatility of the Company's stock.

*Risk-free interest rate* - Based on the U.S. Treasury yield curve and expected life of the options at the time of grant.

*Expected dividends* - Based on the quarterly dividend and the price of the Company's stock at the time of grant.

*Expected life* - Based on a weighted-average of the three-year vesting period and the 10-year contractual term of the stock option plan.

*Grant price for the stock options* - Based on the closing price of the Company's stock at the time of grant.

### ***Restricted Stock Awards***

Restricted stock awards are accounted for as fixed grants using the fair value of the Company's stock at the time of grant. Unvested restricted stock awards may not be disposed of or transferred during the vesting period. Restricted stock awards carry with them the right to receive dividends.

The table below presents the restricted stock award activity:

| <b>Restricted<br/>Stock<br/>Awards</b> | <b>Weighted<br/>Average<br/>Grant</b> |
|--|---------------------------------------|
|--|---------------------------------------|

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|                                 |         |    | <b>Date Fair<br/>Value</b> |
|---------------------------------|---------|----|----------------------------|
| Nonvested at December 31, 2014  | 226,733 | \$ | 17.39                      |
| Granted                         | 3,600   |    | 26.23                      |
| Vested                          | 113,332 |    | 17.39                      |
| Forfeited                       | 2,459   |    | 17.36                      |
| Nonvested at September 30, 2015 | 114,542 | \$ | 17.67                      |
| Nonvested at December 31, 2013  | 340,065 | \$ | 17.39                      |
| Granted                         |         |    |                            |
| Vested                          | 113,332 |    | 17.39                      |
| Forfeited                       |         |    |                            |
| Nonvested at September 30, 2014 | 266,733 | \$ | 17.39                      |

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As of September 30, 2015, the Company had \$1.9 million of unrecognized compensation costs related to restricted stock awards. The cost of the restricted stock awards is being amortized over the three-, five- or six-year vesting period.

**(14) Earnings Per Share**

The table below presents the information used to compute basic and diluted earnings per share:

| (Dollars in thousands, except share data)  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2015                                | 2014      | 2015                               | 2014      |
| Net income                                 | \$ 3,686                            | \$ 3,462  | \$ 11,049                          | \$ 10,643 |
| Weighted-average number of shares used in: |                                     |           |                                    |           |
| Basic earnings per share                   | 9,085,725                           | 9,218,745 | 9,086,481                          | 9,190,476 |
| Dilutive common stock equivalents:         |                                     |           |                                    |           |
| Stock options and restricted stock units   | 215,775                             | 104,561   | 164,354                            | 92,949    |
| Diluted earnings per share                 | 9,301,500                           | 9,323,306 | 9,250,835                          | 9,283,425 |
| Net income per common share, basic         | \$ 0.41                             | \$ 0.38   | \$ 1.22                            | \$ 1.16   |
| Net income per common share, diluted       | \$ 0.40                             | \$ 0.37   | \$ 1.19                            | \$ 1.15   |

We have two forms of our outstanding common stock: common stock and unvested restricted stock awards. Holders of unvested restricted stock awards receive nonforfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings. The computed basic and diluted earnings per share presented are substantially equivalent using both the two-class and the treasury stock methods of calculating earnings per share.

Table of Contents**(15) Other Comprehensive Loss**

The table below presents the changes in the components of accumulated other comprehensive loss, net of taxes:

| (Dollars in thousands)   | Unfunded<br>Pension<br>Liability | Noncredit<br>Related<br>Loss on<br>Trust<br>Preferred<br>Securities | Unrealized<br>Loss on<br>Securities | Total    |
|--|----------------------------------|---|-------------------------------------|----------|
| <b>Three months ended September 30, 2015</b>                   |                                  |   |                                     |          |
| Balances at beginning of period                                | \$ 5,096                         | \$ 176  | \$ 56                               | \$ 5,328 |
| Other comprehensive income, net of taxes                       |                                  | 7   | (8)                                 | (1)      |
| Amounts reclassified from accumulated other comprehensive loss |                                  |   |                                     |          |
| Net current period other comprehensive income                  |                                  | 7   | (8)                                 | (1)      |
| Balances at end of period                                      | \$ 5,096                         | \$ 183  | \$ 48                               | \$ 5,327 |
| <b>Three months ended September 30, 2014</b>                   |                                  |   |                                     |          |
| Balances at beginning of period                                | \$ 3,338                         | \$ 304  | \$ 69                               | \$ 3,711 |
| Other comprehensive income, net of taxes                       |                                  | (3)   | (1)                                 | (4)      |
| Amounts reclassified from accumulated other comprehensive loss |                                  |   |                                     |          |
| Net current period other comprehensive income                  |                                  | (3)   | (1)                                 | (4)      |
| Balances at end of period                                      | \$ 3,338                         | \$ 301  | \$ 68                               | \$ 3,707 |
| <b>Nine months ended September 30, 2015</b>                    |                                  |   |                                     |          |
| Balances at beginning of period                                | \$ 5,032                         | \$ 284  | \$ 72                               | \$ 5,388 |
| Other comprehensive income, net of taxes                       | 64                               | (101)   | (24)                                | (61)     |
| Amounts reclassified from accumulated other comprehensive loss |                                  |   |                                     |          |
| Net current period other comprehensive income                  | 64                               | (101)   | (24)                                | (61)     |
| Balances at end of period                                      | \$ 5,096                         | \$ 183  | \$ 48                               | \$ 5,327 |
| <b>Nine months ended September 30, 2014</b>                    |                                  |   |                                     |          |
| Balances at beginning of period                                | \$ 3,338                         | \$ 376  | \$ 73                               | \$ 3,787 |
| Other comprehensive income, net of taxes                       |                                  | (75)  | (5)                                 | (80)     |
| Amounts reclassified from accumulated other comprehensive loss |                                  |   |                                     |          |
| Net current period other comprehensive income                  |                                  | (75)  | (5)                                 | (80)     |
| Balances at end of period                                      | \$ 3,338                         | \$ 301  | \$ 68                               | \$ 3,707 |

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The table below presents the tax effect on each component of accumulated other comprehensive loss:

| (Dollars in thousands)                               | Pretax Amount | Three Months Ended September 30, |                  |               |             | After Tax Amount |
|--|---------------|----------------------------------|------------------|---------------|-------------|------------------|
|  |               | 2015 Tax                         | After Tax Amount | Pretax Amount | 2014 Tax    |                  |
| Unfunded pension liability                           | \$            | \$                               | \$               | \$            | \$          | \$               |
| Noncredit related loss on trust preferred securities | 12            | (5)                              | 7                | (4)           | 1           | (3)              |
| Unrealized loss on securities                        | (13)          | 5                                | (8)              | (2)           | 1           | (1)              |
| <b>Total</b>   | <b>\$ (1)</b> | <b>\$</b>                        | <b>\$ (1)</b>    | <b>\$ (6)</b> | <b>\$ 2</b> | <b>\$ (4)</b>    |

| (Dollars in thousands)                                 | Pretax Amount   | Nine Months Ended September 30, |                  |                 |              | After Tax Amount |
|--|-----------------|---------------------------------|------------------|-----------------|--------------|------------------|
|  |                 | 2015 Tax                        | After Tax Amount | Pretax Amount   | 2014 Tax     |                  |
| Unfunded pension liability                             | \$ 106          | \$ (42)                         | \$ 64            | \$              | \$           | \$               |
| Noncredit related losses on trust preferred securities | (167)           | 66                              | (101)            | (124)           | 49           | (75)             |
| Unrealized loss on securities                          | (40)            | 16                              | (24)             | (8)             | 3            | (5)              |
| <b>Total</b>   | <b>\$ (101)</b> | <b>\$ 40</b>                    | <b>\$ (61)</b>   | <b>\$ (132)</b> | <b>\$ 52</b> | <b>\$ (80)</b>   |

**(16) Fair Value of Financial Instruments**

In accordance with the Fair Value Measurements and Disclosures topic of the FASB ASC, the Company groups its financial assets and liabilities valued at fair value into three levels based on the markets in which the financial assets and liabilities are traded and the reliability of the assumptions used to determine fair value as follows:

- **Level 1** Valuation is based upon quoted prices (unadjusted) for identical assets or liabilities traded in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.
- **Level 2** Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

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- Level 3 Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect management's own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of discounted cash flow models and similar techniques that require the use of significant judgment or estimation.

In accordance with the Fair Value Measurements and Disclosures topic, the Company bases its fair values on the price that it would expect to receive if an asset were sold or the price that it would expect to pay to transfer a liability in an orderly transaction between market participants at the measurement date. Also as required, the Company maximizes the use of observable inputs and minimizes the use of unobservable inputs when developing fair value measurements.

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The Company uses fair value measurements to determine fair value disclosures. Investment securities held for sale and derivatives are recorded at fair value on a recurring basis. From time to time, the Company may be required to record other financial assets at fair value on a nonrecurring basis, such as loans held for sale, impaired loans and investments, and mortgage servicing assets. These nonrecurring fair value adjustments typically involve application of the lower of cost or fair value accounting or write-downs of individual assets.

*Cash and Cash Equivalents, Accrued Interest Receivable, Current Income Taxes Receivable, Accounts Payable and Accrued Expenses, Current Income Taxes Payable, and Advance Payments by Borrowers for Taxes and Insurance.* The carrying amount approximates fair value because of the short maturity of these instruments.

*Investment Securities.* The estimated fair values of U.S. government-sponsored mortgage-backed securities are considered Level 2 inputs because the valuation for investment securities utilized pricing models that varied based on asset class and included trade, bid and other observable market information.

The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. The trust preferred securities market is considered to be inactive as only six transactions have occurred over the past 45 months in the same tranche of securities we own and no new issues of pooled trust preferred securities have occurred since 2007. The fair value of our trust preferred securities was determined using a discounted cash flow model. Our model used a discount rate equal to three-month LIBOR plus 20.00% and provided a fair value estimate of \$24.16 per \$100 of par value for PreTSL XXIII.

The discounted cash flow analysis included a review of all issuers within the pool. The fair value of the trust preferred securities are classified as Level 3 inputs because they are based on discounted cash flow models.

*FHLB Stock.* FHLB stock, which is redeemable for cash at par value, is reported at its par value.

*FRB Stock.* FRB stock, which is redeemable for cash at par value, is reported at its par value.

*Loans.* The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair value of loans is not based on the concept of exit price.

*Loans Held for Sale.* The fair value of loans held for sale is determined based on the prices quoted in the secondary market for similar loans.



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**Deposits.** The fair value of checking and Super NOW savings accounts, passbook accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated by discounting future cash flows using the rates currently offered for deposits with similar remaining maturities.

**Advances From the FHLB and Securities Sold Under Agreements to Repurchase.** Fair value is estimated by discounting future cash flows using the rates currently offered to the Company for debt with similar remaining maturities.

**Interest Rate Contracts.** The Company may enter into interest rate lock commitments with borrowers on loans intended to be sold. To manage interest rate risk on the lock commitments, the Company may also enter into forward loan sale commitments. The interest rate lock commitments and forward loan sale commitments are treated as derivatives and are recorded at their fair value determined

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by referring to prices quoted in the secondary market for similar contracts. Interest rate contracts that are classified as assets are included with prepaid expenses and other assets on the consolidated balance sheet while interest rate contracts that are classified as liabilities are included with accounts payable and accrued expenses.

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The estimated fair values of the Company's financial instruments are as follows:

| (Dollars in thousands)  | Carrying Amount | Fair Value | Fair Value Measurements Using |         |           |
|---|-----------------|------------|-------------------------------|---------|-----------|
|   |                 |            | Level 1                       | Level 2 | Level 3   |
| <b>September 30, 2015</b>   |                 |            |                               |         |           |
| <b>Assets</b>   |                 |            |                               |         |           |
| Cash and cash equivalents   | \$ 39,466       | \$ 39,466  | \$ 39,466                     | \$      | \$        |
| Investment securities held to maturity                                    | 508,747         | 520,534    |                               | 519,678 | 856       |
| Loans held for sale   | 225             | 232        |                               | 232     |           |
| Loans receivable, net   | 1,163,292       | 1,202,881  |                               |         | 1,202,881 |
| FHLB stock  | 4,590           | 4,590      |                               | 4,590   |           |
| FRB stock   | 2,989           | 2,989      |                               | 2,989   |           |
| Accrued interest receivable   | 4,742           | 4,742      | 4,742                         |         |           |
| Current income taxes receivable   | 1,523           | 1,523      | 1,523                         |         |           |
| Interest rate contracts   | 73              | 73         |                               | 73      |           |
| <b>Liabilities</b>  |                 |            |                               |         |           |
| Deposits  | 1,412,997       | 1,413,975  | 1,177,672                     |         | 236,303   |
| Advances from the Federal Home Loan Bank                                  | 64,000          | 64,941     |                               |         | 64,941    |
| Securities sold under agreements to repurchase                            | 55,000          | 55,857     |                               |         | 55,857    |
| Accounts payable and accrued expenses (excluding interest rate contracts) | 28,518          | 28,518     | 28,518                        |         |           |
| Interest rate contracts   | 64              | 64         |                               | 64      |           |
| Current income taxes payable  | 1,476           | 1,476      | 1,476                         |         |           |
| Advance payments by borrowers for taxes and insurance                     | 3,094           | 3,094      | 3,094                         |         |           |
| <b>December 31, 2014</b>  |                 |            |                               |         |           |
| <b>Assets</b>   |                 |            |                               |         |           |
| Cash and cash equivalents   | \$ 75,060       | \$ 75,060  | \$ 75,060                     | \$      | \$        |
| Investment securities held to maturity                                    | 572,922         | 586,710    |                               | 586,020 | 690       |
| Loans held for sale   | 1,048           | 1,079      |                               | 1,079   |           |
| Loans receivable, net   | 968,212         | 998,183    |                               |         | 998,183   |
| FHLB stock  | 11,234          | 11,234     |                               | 11,234  |           |
| FRB stock   | 2,925           | 2,925      |                               | 2,925   |           |
| Accrued interest receivable   | 4,436           | 4,436      | 4,436                         |         |           |
| Interest rate contracts   | 62              | 62         |                               | 62      |           |
| <b>Liabilities</b>  |                 |            |                               |         |           |
| Deposits  | 1,359,679       | 1,360,074  | 1,137,942                     |         | 222,132   |
| Advances from the Federal Home Loan Bank                                  | 15,000          | 14,977     |                               |         | 14,977    |
| Securities sold under agreements to repurchase                            | 72,000          | 72,334     |                               |         | 72,334    |
| Accounts payable and accrued expenses (excluding interest rate contracts) | 24,044          | 24,044     | 24,044                        |         |           |
| Interest rate contracts   | 54              | 54         |                               | 54      |           |
| Current income taxes payable  | 826             | 826        | 826                           |         |           |
| Advance payments by borrowers for taxes and insurance                     | 3,916           | 3,916      | 3,916                         |         |           |



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At September 30, 2015 and December 31, 2014, neither the commitment fees received on commitments to extend credit nor the fair value thereof was material to the consolidated financial statements of the Company.

The table below presents the balance of assets and liabilities measured at fair value on a recurring basis:

| (Dollars in thousands)     |             | Level 1 | Level 2 | Level 3 | Total |
|----------------------------|-------------|---------|---------|---------|-------|
| <b>September 30, 2015:</b> |             |         |         |         |       |
| Interest rate contracts    | assets      | \$      | \$      | 73      | \$ 73 |
| Interest rate contracts    | liabilities |         |         | (64)    | (64)  |
| <b>December 31, 2014:</b>  |             |         |         |         |       |
| Interest rate contracts    | assets      | \$      | \$      | 62      | \$ 62 |
| Interest rate contracts    | liabilities |         |         | (54)    | (54)  |

The fair value of interest rate contracts was determined by referring to prices quoted in the secondary market for similar contracts.

The table below presents the balance of assets measured at fair value on a nonrecurring basis as of September 30, 2015 and December 31, 2014 and the related gains and losses for the nine months ended September 30, 2015 and the year ended December 31, 2014:

| (Dollars in thousands)     | Level 1 | Level 2 | Level 3 | Total  | Total<br>Gains/<br>(Losses) |
|----------------------------|---------|---------|---------|--------|-----------------------------|
| <b>September 30, 2015:</b> |         |         |         |        |                             |
| Trust preferred securities | \$      | \$      | \$ 856  | \$ 856 | \$ 166                      |
| <b>December 31, 2014:</b>  |         |         |         |        |                             |
| Impaired loans             | \$      | \$      | \$ 327  | \$ 327 | \$ (4)                      |
| Trust preferred securities |         |         | 690     | 690    | 153                         |
| Mortgage servicing assets  |         |         | 505     | 505    | (15)                        |

The fair values of impaired loans that are considered to be collateral-dependent are determined using the value of collateral less estimated selling costs. The fair value of impaired loans not considered to be collateral-dependent is determined using a discounted cash flow analysis. Assumptions used in the analysis include the discount rate and projected cash flows. Changes in the measurement of impaired loans are included in the provision for loan losses in the consolidated statements of income. The fair value of trust preferred securities is determined using a discounted cash flow model. The assumptions used in the discounted cash flow model are discussed above. Gains and losses on trust preferred securities that are credit related are included in net other-than-temporary impairment losses in the consolidated statements of income. Gains and losses on trust preferred securities that are not credit related are included in other comprehensive income in the consolidated statements of comprehensive



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income. Mortgage servicing assets are valued using a discounted cash flow model. Assumptions used in the model include mortgage prepayment speeds, discount rates and cost of servicing. Losses on mortgage servicing assets are included in service fees on loan and deposit accounts in the consolidated statements of income.

The table below presents the significant unobservable inputs for Level 3 nonrecurring fair value measurements:

| (Dollars in thousands)                  | Fair Value | Valuation Technique  | Unobservable Input   | Value                         |
|---|------------|----------------------|--|-------------------------------|
| <b>September 30, 2015:</b>              |            |                      |  |                               |
| Trust preferred securities              | \$ 856     | Discounted cash flow | Discount rate  | Three-month LIBOR plus 20%    |
| <b>December 31, 2014:</b>               |            |                      |  |                               |
| Impaired loans non-collateral dependent | \$ 327     | Discounted cash flow | Discount rate (1)  | 6.10%                         |
| Trust preferred securities              | 690        | Discounted cash flow | Discount rate  | Three-month LIBOR plus 20%    |
| Mortgage servicing assets               | 505        | Discounted cash flow | Discount rate<br>Prepayment speed (PSA)<br>Annual cost to service (per loan) | 10.50%<br>164.8 262.5<br>\$55 |

(1) Represents the yield on contractual cash flows prior to modification in troubled debt restructurings.

### (17) **Subsequent Events**

On October 29, 2015, the Board of Directors of Territorial Bancorp Inc. declared a quarterly cash dividend of \$0.17 per share of common stock. The dividend is expected to be paid on November 27, 2015 to stockholders of record as of November 12, 2015.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Cautionary Statement Regarding Forward-Looking Information**

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This Quarterly Report contains forward-looking statements, which can be identified by the use of words such as estimate, project, believe, intend, anticipate, plan, seek, expect, will, may and words of similar meaning. These forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations;
- statements regarding our business plans, prospects, growth and operating strategies;
- statements regarding the asset quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.



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These forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. We are under no duty to and do not take any obligation to update any forward-looking statements after the date of this Quarterly Report.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either internationally, nationally or in our market areas, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- adverse changes in the securities markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- our ability to enter new markets successfully and capitalize on growth opportunities;
- our ability to successfully integrate acquired entities, if any;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company

Accounting Oversight Board;

- changes in our organization, compensation and benefit plans;
- changes in our financial condition or results of operations that reduce capital available to pay dividends; and
- changes in the financial condition or future prospects of issuers of securities that we own.

Because of these and a wide variety of other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements.

#### **Overview**

We have historically operated as a traditional thrift institution. The significant majority of our assets consist of long-term, fixed-rate residential mortgage loans and mortgage-backed securities, which we have funded primarily with deposit accounts, securities sold under agreements to repurchase and Federal Home Loan Bank advances. This has resulted in our being particularly vulnerable to increases in interest rates, as our interest-bearing liabilities mature or reprice more quickly than our interest-earning assets.

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We have continued our focus on originating one- to four-family residential real estate loans. Our emphasis on conservative loan underwriting has resulted in continued low levels of nonperforming assets. Our nonperforming assets totaled \$5.4 million, or 0.30% of total assets at September 30, 2015, compared to \$4.5 million, or 0.26% of total assets at December 31, 2014. As of September 30, 2015, nonperforming assets consisted primarily of 20 mortgage loans totaling \$5.4 million. Our nonperforming loans and loss experience has enabled us to maintain a relatively low allowance for loan losses in relation to other peer institutions and correspondingly resulted in low levels of provisions for loan losses. Our provisions for loan losses were \$366,000 and \$188,000 for the nine months ended September 30, 2015 and 2014, respectively.

Other than our loans for the construction of one- to four-family residential homes, we do not offer interest only mortgage loans (where the borrower pays interest for an initial period, after which the loan converts to a fully amortizing loan) on one- to four-family residential properties. We also do not offer loans that provide for negative amortization of principal, such as Option ARM loans, where the borrower can pay less than the interest owed on their loan, resulting in an increased principal balance during the life of the loan. We do not offer subprime loans (loans that generally target borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios) or Alt-A loans (traditionally defined as nonconforming loans having less than full documentation). We also do not own any private label mortgage-backed securities that are collateralized by Alt-A, low or no documentation or subprime mortgage loans.

Our operations in recent years have been affected by our efforts to manage our interest rate risk position. For the nine months ended September 30, 2015, we sold \$46.2 million of fixed-rate mortgage loans and obtained a net \$32.0 million of long-term, fixed-rate borrowings. For the nine months ended September 30, 2014, we sold \$26.9 million of fixed-rate mortgage loans while long-term, fixed-rate borrowings remained constant.

Territorial Savings Bank's investments in mortgage-backed securities and collateralized mortgage obligations have been issued by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. These agencies guarantee the payment of principal and interest on the Bank's mortgage-backed securities. We do not own any preferred stock issued by Fannie Mae or Freddie Mac. As of September 30, 2015, our borrowing capacity at the Federal Home Loan Bank was \$546.0 million compared to \$399.0 million at December 31, 2014.

**Critical Accounting Policies**

There are no material changes to the critical accounting policies disclosed in Territorial Bancorp Inc.'s Annual Report on Form 10-K for the year ended December 31, 2014.

**Comparison of Financial Condition at September 30, 2015 and December 31, 2014**

*Assets.* At September 30, 2015, our assets were \$1.784 billion, an increase of \$91.6 million, or 5.4%, from \$1.692 billion at December 31, 2014. The increase in assets was primarily the result of a \$194.3 million increase in total loans that was partially offset by a \$35.6 million decrease in cash and a \$64.2 million decrease in investment securities.



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**Cash and Cash Equivalents.** Cash and cash equivalents were \$39.5 million at September 30, 2015, a decrease of \$35.6 million since December 31, 2014. The decrease in cash and cash equivalents was primarily caused by funding a \$194.3 million increase in total loans, the payoff of \$17.0 million of securities sold under agreements to repurchase, the repurchase of \$7.9 million of common stock and the payment of \$4.6 million of common stock dividends. These decreases in cash and cash equivalents were partially offset by funds received from a \$64.2 million decrease in investment securities, \$49.0 million of net new FHLB advances, a \$53.3 million increase in deposits, \$11.0 million of net income and \$6.6 million of net FHLB stock redemptions.

**Loans.** Total loans, including \$225,000 of loans held for sale, were \$1.164 billion at September 30, 2015, or 65.2% of total assets. During the nine months ended September 30, 2015, the loan portfolio, including loans held for sale, increased by \$194.3 million, or 20.0%. The increase in the loan portfolio primarily occurred as the production of new one- to four-family residential loans exceeded principal repayments and loan sales.

**Securities.** At September 30, 2015, our securities portfolio totaled \$508.7 million, or 28.5% of total assets. During the nine months ended September 30, 2015, the securities portfolio decreased by \$64.2 million, or 11.2%. The decrease in the securities portfolio occurred as repayments and the amount of securities sold exceeded the amount of securities purchased.

At September 30, 2015, all of such securities were classified as held-to-maturity and none of the underlying collateral consisted of subprime or Alt-A (traditionally defined as nonconforming loans having less than full documentation) loans.

At September 30, 2015, we owned a trust preferred security with an amortized cost of \$856,000. This security represents an investment in a pool of debt obligations primarily issued by holding companies of Federal Deposit Insurance Corporation-insured financial institutions.

The trust preferred securities market is considered to be inactive as only six transactions have occurred over the past 45 months in the same tranche of securities that we own and no new issues of pooled trust preferred securities have occurred since 2007. We use a discounted cash flow model to determine whether this security is other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows. We used a discount rate equal to three-month LIBOR plus 20.00% and provided a fair value estimate of \$24.16 per \$100 of par value for PreTSL XXIII.

Based on the Company's review, the Company's investment in the trust preferred security did not incur additional impairment during the nine months ended September 30, 2015.

It is reasonably possible that the fair value of the trust preferred security could decline in the near term if the overall economy and the financial condition of some of the issuers continue to deteriorate and the liquidity of this security remains low. As a result, there is a risk that the Company's remaining cost basis of \$1.1 million on its trust preferred security could be credit-related other-than-temporarily impaired in the near

term. The impairment, if any, could be material to the Company's consolidated statements of income.

*Deposits.* Deposits were \$1.413 billion at September 30, 2015, an increase of \$53.3 million, or 3.9%, since December 31, 2014. The growth in deposits was primarily due to an increase of \$39.1 million in savings and checking accounts and a \$13.6 million increase in certificates of deposit during the nine months ended September 30, 2015.

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**Borrowings.** Our borrowings consist of advances from the Federal Home Loan Bank and funds borrowed under securities sold under agreements to repurchase. During the nine months ended September 30, 2015, total borrowings increased to \$119.0 million as Federal Home Loan Bank advances rose by \$49.0 million while securities sold under agreements to repurchase decreased by \$17.0 million. We have not required any other borrowings to fund our operations. Instead, we have primarily funded our operations with additional deposits, proceeds from loan sales and principal repayments on loans and mortgage-backed securities.

**Average Balances and Yields**

The following tables set forth average balance sheets, average yields and rates, and certain other information at and for the periods indicated. No tax-equivalent yield adjustments were made, as the effect thereof was not material. All average balances are daily average balances. Nonaccrual loans were included in the computation of average balances, but have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of net deferred costs, discounts and premiums that are amortized or accreted to interest income.

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|  | For the Three Months Ended September 30, |           |                    |                                   |           |                    |
|--|--|-----------|--------------------|-----------------------------------|-----------|--------------------|
|  | 2015                                     |           |                    | 2014                              |           |                    |
|  | Average<br>Outstanding<br>Balance        | Interest  | Yield/<br>Rate (1) | Average<br>Outstanding<br>Balance | Interest  | Yield/<br>Rate (1) |
|  | (Dollars in thousands)                   |           |                    |                                   |           |                    |
| <b>Interest-earning assets:</b>                          |  |           |                    |                                   |           |                    |
| Loans:   |  |           |                    |                                   |           |                    |
| Real estate loans:                                       |  |           |                    |                                   |           |                    |
| First mortgage:  |  |           |                    |                                   |           |                    |
| One- to four-family residential (2)                      | \$ 1,090,007                             | \$ 11,267 | 4.13%              | \$ 870,909                        | \$ 9,448  | 4.34%              |
| Multi-family residential                                 | 9,906                                    | 116       | 4.68               | 5,068                             | 71        | 5.60               |
| Construction, commercial and other                       | 16,584                                   | 190       | 4.58               | 20,030                            | 247       | 4.93               |
| Home equity loans and lines of credit                    | 15,374                                   | 173       | 4.50               | 15,341                            | 184       | 4.80               |
| Other loans  | 4,602                                    | 63        | 5.48               | 4,824                             | 70        | 5.80               |
| Total loans  | 1,136,473                                | 11,809    | 4.16               | 916,172                           | 10,020    | 4.37               |
| Investment securities:                                   |  |           |                    |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities (2) | 515,392                                  | 4,098     | 3.18               | 600,548                           | 4,895     | 3.26               |
| Trust preferred securities                               | 868                                      |           |                    | 656                               |           |                    |
| Total securities   | 516,260                                  | 4,098     | 3.18               | 601,204                           | 4,895     | 3.26               |
| Other  | 37,698                                   | 64        | 0.68               | 75,588                            | 75        | 0.40               |
| Total interest-earning assets                            | 1,690,431                                | 15,971    | 3.78               | 1,592,964                         | 14,990    | 3.76               |
| Non-interest-earning assets                              | 68,151                                   |           |                    | 65,639                            |           |                    |
| Total assets   | \$ 1,758,582                             |           |                    | \$ 1,658,603                      |           |                    |
| <b>Interest-bearing liabilities:</b>                     |  |           |                    |                                   |           |                    |
| Savings accounts   | \$ 960,881                               | \$ 917    | 0.38%              | \$ 931,040                        | \$ 868    | 0.37%              |
| Certificates of deposit                                  | 223,897                                  | 271       | 0.48               | 211,426                           | 263       | 0.50               |
| Money market accounts                                    | 1,209                                    | 1         | 0.33               | 776                               |           |                    |
| Checking and Super NOW accounts                          | 159,102                                  | 9         | 0.02               | 144,190                           | 7         | 0.02               |
| Total interest-bearing deposits                          | 1,345,089                                | 1,198     | 0.36               | 1,287,432                         | 1,138     | 0.35               |
| Federal Home Loan Bank advances                          | 55,227                                   | 211       | 1.53               | 15,000                            | 67        | 1.79               |
| Securities sold under agreements to repurchase           | 55,325                                   | 221       | 1.60               | 72,000                            | 346       | 1.92               |
| Total interest-bearing liabilities                       | 1,455,641                                | 1,630     | 0.45               | 1,374,432                         | 1,551     | 0.45               |
| Non-interest-bearing liabilities                         | 82,602                                   |           |                    | 67,247                            |           |                    |
| Total liabilities  | 1,538,243                                |           |                    | 1,441,679                         |           |                    |
| Stockholders' equity                                     | 220,339                                  |           |                    | 216,924                           |           |                    |
| Total liabilities and stockholders' equity               | \$ 1,758,582                             |           |                    | \$ 1,658,603                      |           |                    |
| Net interest income                                      |  | \$ 14,341 |                    |                                   | \$ 13,439 |                    |
| Net interest rate spread (3)                             |  |           | 3.33%              |                                   |           | 3.31%              |
| Net interest-earning assets (4)                          | \$ 234,790                               |           |                    | \$ 218,532                        |           |                    |
| Net interest margin (5)                                  |  |           | 3.39%              |                                   |           | 3.37%              |
| Interest-earning assets to interest-bearing liabilities  | 116.13%                                  |           |                    | 115.90%                           |           |                    |

(1) Annualized

(2) Average balance includes loans or investments available for sale, as applicable.



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- (3) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.
- (4) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
- (5) Net interest margin represents net interest income divided by average total interest-earning assets.

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|  | For the Nine Months Ended September 30, |           |                    |                                   |           |                    |
|--|---|-----------|--------------------|-----------------------------------|-----------|--------------------|
|  | 2015                                    |           |                    | 2014                              |           |                    |
|  | Average<br>Outstanding<br>Balance       | Interest  | Yield/<br>Rate (1) | Average<br>Outstanding<br>Balance | Interest  | Yield/<br>Rate (1) |
|  | (Dollars in thousands)                  |           |                    |                                   |           |                    |
| <b>Interest-earning assets:</b>                          |   |           |                    |                                   |           |                    |
| Loans:   |   |           |                    |                                   |           |                    |
| Real estate loans:                                       |   |           |                    |                                   |           |                    |
| First mortgage:  |   |           |                    |                                   |           |                    |
| One- to four-family residential (2)                      | \$ 1,022,525                            | \$ 32,073 | 4.18%              | \$ 846,210                        | \$ 27,666 | 4.36%              |
| Multi-family residential                                 | 9,634                                   | 343       | 4.75               | 4,887                             | 206       | 5.62               |
| Construction, commercial and other                       | 17,932                                  | 617       | 4.59               | 17,767                            | 669       | 5.02               |
| Home equity loans and lines of credit                    | 15,801                                  | 546       | 4.61               | 15,756                            | 575       | 4.87               |
| Other loans  | 4,451                                   | 182       | 5.45               | 4,706                             | 204       | 5.78               |
| Total loans  | 1,070,343                               | 33,761    | 4.21               | 889,326                           | 29,320    | 4.40               |
| Investment securities:                                   |   |           |                    |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities (2) | 539,300                                 | 12,895    | 3.19               | 612,974                           | 15,055    | 3.27               |
| Trust preferred securities                               | 768                                     |           |                    | 617                               |           |                    |
| Total securities   | 540,068                                 | 12,895    | 3.18               | 613,591                           | 15,055    | 3.27               |
| Other  | 55,235                                  | 213       | 0.51               | 76,444                            | 153       | 0.27               |
| Total interest-earning assets                            | 1,665,646                               | 46,869    | 3.75               | 1,579,361                         | 44,528    | 3.76               |
| Non-interest-earning assets                              | 66,996                                  |           |                    | 65,188                            |           |                    |
| Total assets   | \$ 1,732,642                            |           |                    | \$ 1,644,549                      |           |                    |
| <b>Interest-bearing liabilities:</b>                     |   |           |                    |                                   |           |                    |
| Savings accounts   | \$ 957,623                              | \$ 2,675  | 0.37%              | \$ 923,436                        | \$ 2,507  | 0.36%              |
| Certificates of deposit                                  | 221,849                                 | 784       | 0.47               | 211,389                           | 802       | 0.51               |
| Money market accounts                                    | 975                                     | 2         | 0.27               | 817                               | 1         | 0.16               |
| Checking and Super NOW accounts                          | 154,398                                 | 25        | 0.02               | 141,908                           | 22        | 0.02               |
| Total interest-bearing deposits                          | 1,334,845                               | 3,486     | 0.35               | 1,277,550                         | 3,332     | 0.35               |
| Federal Home Loan Bank advances                          | 38,571                                  | 438       | 1.51               | 15,000                            | 199       | 1.77               |
| Securities sold under agreements to repurchase           | 61,703                                  | 776       | 1.68               | 72,000                            | 1,032     | 1.91               |
| Total interest-bearing liabilities                       | 1,435,119                               | 4,700     | 0.44               | 1,364,550                         | 4,563     | 0.45               |
| Non-interest-bearing liabilities                         | 79,059                                  |           |                    | 65,821                            |           |                    |
| Total liabilities  | 1,514,178                               |           |                    | 1,430,371                         |           |                    |
| Stockholders' equity                                     | 218,464                                 |           |                    | 214,178                           |           |                    |
| Total liabilities and stockholders' equity               | \$ 1,732,642                            |           |                    | \$ 1,644,549                      |           |                    |
| Net interest income                                      |   | \$ 42,169 |                    |                                   | \$ 39,965 |                    |
| Net interest rate spread (3)                             |   |           | 3.31%              |                                   |           | 3.31%              |
| Net interest-earning assets (4)                          | \$ 230,527                              |           |                    | \$ 214,811                        |           |                    |
| Net interest margin (5)                                  |   |           | 3.38%              |                                   |           | 3.37%              |
| Interest-earning assets to interest-bearing liabilities  | 116.06%                                 |           |                    | 115.74%                           |           |                    |

(1) Annualized

(2) Average balance includes loans or investments available for sale, as applicable.

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- (3) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.
- (4) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
- (5) Net interest margin represents net interest income divided by average total interest-earning assets.

Table of Contents**Comparison of Operating Results for the Three Months Ended September 30, 2015 and 2014**

**General.** Net income increased by \$224,000, or 6.5%, from \$3.5 million for the three months ended September 30, 2014 to \$3.7 million for the three months ended September 30, 2015. The increase in net income was primarily due to a \$981,000 increase in interest and dividend income. This was partially offset by a \$287,000 increase in noninterest expense, a \$133,000 increase in income taxes, a \$79,000 increase in interest expense, a \$48,000 increase in the provision for loan losses and a \$210,000 decrease in noninterest income.

**Net Interest Income.** Net interest income increased by \$902,000, or 6.7%, to \$14.3 million for the three months ended September 30, 2015 compared to \$13.4 million for the three months ended September 30, 2014. Interest and dividend income increased by \$981,000, or 6.5%, due to a \$97.5 million increase in the average balance of interest-earning assets as well as a two basis point increase in the average yield on interest earning assets. Interest expense increased by \$79,000, or 5.1%, due to an \$81.2 million increase in the average balance of interest-bearing liabilities. The interest rate spread and net interest margin were 3.33% and 3.39%, respectively, for the three months ended September 30, 2015, compared to 3.31% and 3.37%, respectively, for the three months ended September 30, 2014.

**Interest and Dividend Income.** Interest and dividend income increased by \$981,000, or 6.5%, to \$16.0 million for the three months ended September 30, 2015 from \$15.0 million for the three months ended September 30, 2014. Interest income on loans increased by \$1.8 million, or 17.9%, to \$11.8 million for the three months ended September 30, 2015 from \$10.0 million for the three months ended September 30, 2014. The increase in interest income on loans occurred because the average balance of loans grew by \$220.3 million, or 24.0%, as new loan originations exceeded loan repayments and loan sales. The increase in interest income that occurred because of growth in the loan portfolio was partially offset by a 21 basis point decline in the average loan yield to 4.16% for the three months ended September 30, 2015. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio. Interest income on investment securities decreased by \$797,000, or 16.3%, to \$4.1 million for the three months ended September 30, 2015 from \$4.9 million for the three months ended September 30, 2014. The decrease in interest income on securities occurred because of an \$85.0 million decrease in the average securities balance and an eight basis point decrease in the average securities yield. The decrease in the securities yield occurred as higher yielding securities were paid off and new securities with lower yields were added to the investment portfolio.

**Interest Expense.** Interest expense increased by \$79,000, or 5.1%, to \$1.6 million for the three months ended September 30, 2015. Interest expense on FHLB advances increased by \$144,000, or 214.9%, during the three months ended September 30, 2015 compared to the three months ended September 30, 2014. The increase in interest expense was primarily due to a \$40.2 million, or 268.2%, increase in the average balance of FHLB advances. This was partially offset by a 26 basis point decrease in the average interest rate to 1.53% for the three months ended September 30, 2015 compared to 1.79% for the three months ended September 30, 2014. Additional advances were obtained during the three months ended September 30, 2015 to extend the maturity of liabilities and reduce interest rate risk. Interest expense on deposits increased by \$60,000, or 5.3%, from \$1.1 million for the three months ended

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September 30, 2014 to \$1.2 billion for the three months ended September 30, 2015. The average outstanding balance of deposits increased by \$57.7 million, or 4.5%, to \$1.345 billion for the three months ended September 30, 2015 compared to \$1.287 billion for the three months ended September 30, 2014. The average interest rate on deposits increased to 0.36% from 0.35% during the three months ended September 30, 2015 compared to the three months ended September 30, 2014. Interest expense on

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securities sold under agreements to repurchase decreased by \$125,000, or 36.1%, during the three months ended September 30, 2015 compared to the three months ended September 30, 2014. The decrease was caused by a \$16.7 million, or 23.2%, decrease in the average outstanding balance of securities sold under agreements to repurchase. The decrease in the average balance was augmented by a 32 basis point decrease in the interest rate to 1.60% for the three months ended September 30, 2015 from 1.92% for the three months ended September 30, 2014. The decline in the average balance of securities sold under agreements to repurchase occurred as the Company paid off maturing borrowings.

**Provision for Loan Losses.** We recorded provisions for loan losses of \$71,000 and \$23,000 for the three months ended September 30, 2015 and 2014, respectively. The provisions for loan losses included net charge-offs of \$3,000 for the three months ended September 30, 2015 and net charge-offs of \$5,000 for the three months ended September 30, 2014. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.18% and 0.17% at September 30, 2015 and 2014, respectively. Nonaccrual loans totaled \$5.4 million at September 30, 2015, or 0.46% of total loans at that date, compared to \$5.0 million of nonaccrual loans at September 30, 2014, or 0.54% of total loans at that date. Nonaccrual loans as of September 30, 2015 and 2014 consisted primarily of one- to four-family residential real estate loans. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2015 and 2014. For additional information see note (6), Loans Receivable and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

**Noninterest Income.** The following table summarizes changes in noninterest income between the three months ended September 30, 2015 and 2014.

|   | Three Months Ended<br>September 30, |          | Change    |          |
|---|-------------------------------------|----------|-----------|----------|
|   | 2015                                | 2014     | \$ Change | % Change |
|   | (Dollars in thousands)              |          |           |          |
| Service fees on loan and deposit accounts | \$ 590                              | \$ 555   | \$ 35     | 6.3%     |
| Income on bank-owned life insurance       | 259                                 | 265      | (6)       | (2.3)%   |
| Gain on sale of investment securities     |                                     | 392      | (392)     | (100.0)% |
| Gain on sale of loans                     | 201                                 | 118      | 83        | 70.3%    |
| Other                                     | 138                                 | 68       | 70        | 102.9%   |
| Total                                     | \$ 1,188                            | \$ 1,398 | \$ (210)  | (15.0)%  |

Noninterest income decreased by \$210,000 for the three months ended September 30, 2015 compared to the three months ended September 30, 2014. During the three months ended September 30, 2014, the Company received proceeds of \$4.3 million from the sale of \$3.9 million of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$392,000. The sale of these mortgage-backed securities, for which the Company had already collected a substantial portion of the original purchased principal (at least 85%), is in accordance with the Investments Debt and Equity Securities topic of the FASB ASC and does not taint management's assertion of intent to hold remaining securities in the held-to-maturity portfolio to maturity. During the three months ended September 30, 2015, the Company did not sell any investment securities. During the three months ended September 30, 2015 and 2014, the Company sold \$17.7 million and \$10.0 million, respectively, of mortgage loans held for sale and recognized gains of \$201,000 and \$118,000, respectively. Other noninterest income increased by \$70,000 during the three months ended September 30, 2015 compared to the three months ended September 30, 2014 due to an increase in insurance commission income.



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**Noninterest Expense.** The following table summarizes changes in noninterest expense between the three months ended September 30, 2015 and 2014.

|   | Three Months Ended<br>September 30, |          | Change    |          |
|---|-------------------------------------|----------|-----------|----------|
|   | 2015                                | 2014     | \$ Change | % Change |
|   | (Dollars in thousands)              |          |           |          |
| Salaries and employee benefits            | \$ 5,596                            | \$ 5,402 | \$ 194    | 3.6%     |
| Occupancy                                 | 1,483                               | 1,474    | 9         | 0.6%     |
| Equipment                                 | 1,025                               | 956      | 69        | 7.2%     |
| Federal deposit insurance premiums        | 214                                 | 202      | 12        | 5.9%     |
| Other general and administrative expenses | 1,048                               | 1,045    | 3         | 0.3%     |
| Total                                     | \$ 9,366                            | \$ 9,079 | \$ 287    | 3.2%     |

Noninterest expense rose by \$287,000 for the three months ended September 30, 2015 compared to the three months ended September 30, 2014. Salaries and employee benefits expense increased by \$194,000 to \$5.6 million for the three months ended September 30, 2015 from \$5.4 million for the three months ended September 30, 2014. The increase in salaries and employee benefits was primarily due to a bank-wide budgeted salary increase of approximately 3.0%, which was effective July 1, 2015, higher loan officer compensation that occurred primarily because of the increase in new loan originations, and the hiring of additional staff to originate loans and to handle the additional workload associated with an increase in regulatory requirements. The rise in these expenses was offset by an increase in the credit to compensation expense because of an increase in the number of new loan originations. The Receivables topic of FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating new loans. Equipment expenses increased by \$69,000 to \$1.0 million for the three months ending September 30, 2015 from \$956,000 for the three months ended September 30, 2014. The rise in equipment expense was primarily due to increases in data processing, equipment acquisition and equipment maintenance expenses.

**Income Tax Expense.** Income taxes were \$2.4 million for the three months ended September 30, 2015, reflecting an effective tax rate of 39.5%, compared to \$2.3 million for the three months ended September 30, 2014, reflecting an effective tax rate of 39.6%.

#### Comparison of Operating Results for the Nine Months Ended September 30, 2015 and 2014

**General.** Net income increased by \$406,000, or 3.8%, from \$10.6 million for the nine months ended September 30, 2014 to \$11.0 million for the nine months ended September 30, 2015. The increase in net income was primarily due to a \$2.3 million increase in interest and dividend income. This was partially offset by an \$844,000 increase in income taxes, a \$423,000 increase in noninterest expense, a \$178,000 increase in the provision for loan losses, a \$137,000 increase in interest expense and a \$353,000 decrease in noninterest income.

**Net Interest Income.** Net interest income increased by \$2.2 million, or 5.5%, to \$42.2 million for the nine months ended September 30, 2015 compared to \$40.0 million for the nine months ended September 30, 2014. Interest and dividend income increased by \$2.3 million, or 5.3%, due to an \$86.3 million increase in the average balance of interest-earning



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assets that was partially offset by a one basis point decline in the average yield on interest earning assets. Interest expense increased by \$137,000, or 3.0%, due to a \$70.6 million increase in the average balance of interest-bearing liabilities that was partially offset by a one basis point decrease in the average cost of interest-bearing liabilities. The interest rate spread and net interest margin were 3.31% and 3.38%, respectively, for the nine months ended September 30, 2015, compared to 3.31% and 3.37%, respectively, for the nine months ended September 30, 2014.

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**Interest and Dividend Income.** Interest and dividend income increased by \$2.3 million, or 5.3%, to \$46.9 million for the nine months ended September 30, 2015 from \$44.5 million for the nine months ended September 30, 2014. Interest income on loans increased by \$4.4 million, or 15.1%, to \$33.8 million for the nine months ended September 30, 2015 from \$29.3 million for the nine months ended September 30, 2014. The increase in interest income on loans occurred because the average balance of loans grew by \$181.0 million, or 20.4%, as new loan originations exceeded loan repayments and loan sales. The increase in interest income that occurred because of growth in the loan portfolio was partially offset by a 19 basis point decline in the average loan yield to 4.21% for the nine months ended September 30, 2015. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio. Interest income on investment securities decreased by \$2.2 million, or 14.3%, to \$12.9 million for the nine months ended September 30, 2015 from \$15.1 million for the nine months ended September 30, 2014. The decrease in interest income on securities occurred because of a \$73.5 million decrease in the average securities balance and a nine basis point decrease in the average securities yield.

**Interest Expense.** Interest expense increased by \$137,000, or 3.0% from \$4.6 million for the nine months ended September 30, 2014 to \$4.7 million for the nine months ended September 30, 2015. Interest expense on FHLB advances increased by \$239,000, or 120.1%, during the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. The increase in interest expense was primarily due to a \$23.6 million, or 157.1%, increase in the average balance of FHLB advances. This was partially offset by a 26 basis point decrease in the average interest rate to 1.51% for the nine months ended September 30, 2015 compared to 1.77% for the nine months ended September 30, 2014. Additional advances were obtained during the nine months ended September 30, 2015 to extend the maturity of liabilities and reduce interest rate risk. Interest expense on deposits increased by \$154,000, or 4.6%, from \$3.3 million for the nine months ended September 30, 2014 to \$3.5 million for the nine months ended September 30, 2015. The average outstanding balance of deposits increased by \$57.3 million, or 4.5%, to \$1.335 billion for the nine months ended September 30, 2015 compared to \$1.278 billion for the nine months ended September 30, 2014. The average interest rate on deposits remained constant at 0.35% during the nine months ended September 30, 2015 and 2014. Interest expense on securities sold under agreements to repurchase decreased by \$256,000, or 24.8%, during the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. The decrease in interest expense was caused by a \$10.3 million, or 14.3%, decrease in the average outstanding balance of securities sold under agreements to repurchase. The decrease in the average balance was augmented by a 23 basis point decrease in the interest rate to 1.68% for the nine months ended September 30, 2015 from 1.91% for the nine months ended September 30, 2014. The decline in the average balance of securities sold under agreements to repurchase occurred as the Company paid off maturing borrowings.

**Provision for Loan Losses.** We recorded provisions for loan losses of \$366,000 and \$188,000 for the nine months ended September 30, 2015 and 2014, respectively. The provisions for loan losses included net recoveries of \$5,000 for the nine months ended September 30, 2015 and net charge-offs of \$146,000 for the nine months ended September 30, 2014. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.18% and 0.17% at September 30, 2015 and 2014, respectively. Nonaccrual loans totaled \$5.4 million at September 30, 2015, or 0.46% of total loans at that date, compared to \$5.0 million of nonaccrual loans at September 30, 2014, or 0.54% of total loans at that date. Nonaccrual loans as of September 30, 2015 and 2014 consisted primarily of one- to four-family residential real estate loans. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2015 and 2014. For additional information see note (6), Loans Receivable

and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

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**Noninterest Income.** The following table summarizes changes in noninterest income between the nine months ended September 30, 2015 and 2014.

|   | Nine Months Ended<br>September 30, |          | Change    |          |
|---|------------------------------------|----------|-----------|----------|
|   | 2015                               | 2014     | \$ Change | % Change |
|   | (Dollars in thousands)             |          |           |          |
| Service fees on loan and deposit accounts | \$ 1,577                           | \$ 1,578 | \$ (1)    | (0.1)%   |
| Income on bank-owned life insurance       | 770                                | 797      | (27)      | (3.4)%   |
| Gain on sale of investment securities     | 476                                | 1,047    | (571)     | (54.5)%  |
| Gain on sale of loans                     | 440                                | 283      | 157       | 55.5%    |
| Other                                     | 419                                | 330      | 89        | 27.0%    |
| Total                                     | \$ 3,682                           | \$ 4,035 | \$ (353)  | (8.7)%   |

Noninterest income decreased by \$353,000 for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. During the nine months ended September 30, 2015 and 2014, the Company received proceeds of \$5.0 million and \$11.5 million, respectively, from the sale of \$4.6 million and \$10.5 million, respectively, of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$415,000 and \$1.0 million, respectively. The sale of these mortgage-backed securities, for which the Company had already collected a substantial portion of the original purchased principal (at least 85%), is in accordance with the Investments – Debt and Equity Securities topic of the FASB ASC and does not taint management’s assertion of intent to hold remaining securities in the held-to-maturity portfolio to maturity. In addition, during the nine months ended September 30, 2015, we sold a trust preferred security that was previously written off and recognized a gain of \$61,000, and during the nine months ended September 30, 2014, we sold a \$5.0 million held-for-trading investment security and recognized a gain of \$30,000. During the nine months ended September 30, 2015 and 2014, the Company sold \$46.2 million and \$26.9 million, respectively, of mortgage loans held for sale and recognized gains of \$440,000 and \$283,000, respectively. Other noninterest income increased by \$89,000 during the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 primarily due to an increase in insurance commission income.

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**Noninterest Expense.** The following table summarizes changes in noninterest expense between the nine months ended September 30, 2015 and 2014.

|   | Nine Months Ended<br>September 30, |           | Change    |          |
|---|------------------------------------|-----------|-----------|----------|
|   | 2015                               | 2014      | \$ Change | % Change |
|   | (Dollars in thousands)             |           |           |          |
| Salaries and employee benefits            | \$ 15,759                          | \$ 16,062 | \$ (303)  | (1.9)%   |
| Occupancy                                 | 4,348                              | 4,305     | 43        | 1.0%     |
| Equipment                                 | 2,923                              | 2,775     | 148       | 5.3%     |
| Federal deposit insurance premiums        | 634                                | 602       | 32        | 5.3%     |
| Other general and administrative expenses | 3,449                              | 2,946     | 503       | 17.1%    |
| Total                                     | \$ 27,113                          | \$ 26,690 | \$ 423    | 1.6%     |

Noninterest expense rose by \$423,000 for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. Other general and administrative expenses increased by \$503,000 to \$3.4 million for the nine months ended September 30, 2015 from \$2.9 million for the nine months ended September 30, 2014. The increase was primarily due to increases in advertising expenses, auditing expenses, other loan expenses, and other professional fees. This was partially offset by a decrease in legal expenses and supervisory examination fees. Salaries and employee benefits expense decreased by \$303,000 to \$15.8 million for the nine months ended September 30, 2015 from \$16.1 million for the nine months ended September 30, 2014. The Company recognized a \$1.4 million increase in the credit to compensation expense for the cost of originating new mortgage loans because of an increase in new loan originations. The Receivables topic of the FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating loans. This was partially offset by bank-wide budgeted salary increases of approximately 3.0% and 2.0%, which were effective July 1, 2015 and 2014 respectively, and higher loan officer compensation that occurred primarily because of the increase in new loan originations. Equipment expenses increased by \$148,000 to \$2.9 million for the nine months ended September 30, 2015 from \$2.8 million for the nine months ended September 30, 2014. The rise in equipment expense is primarily due to increases in data processing, equipment acquisition and equipment maintenance expenses.

**Income Tax Expense.** Income taxes were \$7.3 million for the nine months ended September 30, 2015, reflecting an effective tax rate of 39.9%, compared to \$6.5 million for the nine months ended September 30, 2014, reflecting an effective tax rate of 37.8%. The increase in the effective tax rate is primarily due to a decrease in permanent tax benefits related to our share-based compensation plans and an increase in deferred tax rates.

### Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, cash balances at the Federal Reserve Bank, loan repayments, advances from the Federal Home Loan Bank, securities sold under agreements to repurchase, proceeds from loan sales and principal repayments on securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We have established an Asset/Liability Management Committee, consisting of our President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Chief Financial Officer and our Vice President and Controller, which is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs



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and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of September 30, 2015.

We regularly monitor and adjust our investments in liquid assets based upon our assessment of:

- (i) expected loan demand;
- (ii) purchases and sales of investment securities;
- (iii) expected deposit flows and borrowing maturities;
- (iv) yields available on interest-earning deposits and securities; and
- (v) the objectives of our asset/liability management program.

Excess liquid assets are invested generally in interest-earning deposits or securities and may also be used to pay off short-term borrowings.

Our most liquid asset is cash. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2015, our cash and cash equivalents totaled \$39.5 million. On that date, we had \$55.0 million in securities sold under agreements to repurchase outstanding and \$64.0 million of Federal Home Loan Bank advances outstanding, with the ability to borrow an additional \$546.0 million under Federal Home Loan Bank advances.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our Consolidated Statements of Cash Flows included in our Consolidated Financial Statements.

At September 30, 2015, we had \$22.4 million in loan commitments outstanding, most of which were for fixed-rate loans, and had \$26.4 million in unused lines of credit to borrowers. Certificates of deposit due within one year at September 30, 2015 totaled \$181.4 million, or 12.8% of total deposits. If these deposits do not remain with us, we may be required to seek other sources of funds, including loan sales, brokered deposits, securities sold under agreements to repurchase and Federal Home Loan Bank advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before September 30, 2016. We believe, however, based on past experience, that a significant portion of such deposits will remain with us. We have

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the ability to attract and retain deposits by adjusting the interest rates offered.

Our primary investing activities are originating loans and purchasing mortgage-backed securities. During the nine months ended September 30, 2015 and 2014, we originated \$364.0 million and \$168.6 million of loans, respectively, and purchased \$10.1 million and \$39.9 million of securities, respectively.

Financing activities consist primarily of activity in deposit accounts, Federal Home Loan Bank advances, securities sold under agreements to repurchase, stock repurchases and dividend payments. We experienced a net increase in deposits of \$53.3 million and \$38.5 million for the nine months ended September 30, 2015 and 2014, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the Federal Home Loan Bank, which provide an additional source of funds. Federal Home Loan Bank advances increased by \$49.0 million during the nine months ended September 30, 2015 to \$64.0 million and



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remained constant at \$15.0 million during the nine months ended September 30, 2014. We had the ability to borrow up to an additional \$546.0 million and \$399.0 million from the Federal Home Loan Bank as of September 30, 2015 and December 31, 2014, respectively. The increase in our borrowing capacity is due to a higher credit line at the Federal Home Loan Bank. We also utilize securities sold under agreements to repurchase as another borrowing source. Securities sold under agreements to repurchase decreased by \$17.0 million to \$55.0 million at September 30, 2015 and remained constant at \$72.0 million for the nine months ended September 30, 2014.

Territorial Bancorp Inc. is a separate legal entity from Territorial Savings Bank and must provide for its own liquidity to pay dividends, repurchase shares of its common stock and for other corporate purposes. Territorial Bancorp Inc.'s primary source of liquidity is dividend payments from Territorial Savings Bank. The ability of Territorial Savings Bank to pay dividends to Territorial Bancorp Inc. is subject to regulatory requirements. At September 30, 2015, Territorial Bancorp Inc. (on an unconsolidated, stand-alone basis) had liquid assets of \$5.9 million.

Territorial Savings Bank and the Company are subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. On July 10, 2014, Territorial Savings Bank became a member of the Federal Reserve System. The Federal Reserve requires that Territorial Savings Bank maintain a Tier 1 Leverage Capital ratio of 9.0% for three years as a condition of membership. Effective January 1, 2015, the well capitalized threshold for Tier 1 risk-based capital was increased from 6.0% to 8.0% and a new capital standard, common equity tier 1 risk-based capital, was implemented with a 6.5% ratio requirement for a financial institution to be considered well capitalized. Additionally, effective January 1, 2015, consolidated regulatory capital requirements identical to those applicable to the subsidiary depository institutions became applicable to savings and loan holding companies over \$1.0 billion in assets, such as the Company. At September 30, 2015, Territorial Savings Bank and the Company exceeded all regulatory capital requirements and are considered to be well capitalized under regulatory guidelines. The tables below present the capital required to be considered well-capitalized as a percentage of total and risk-weighted assets and the percentage and the total amount of capital maintained for both Territorial Savings Bank and the Company at September 30, 2015 and for Territorial Savings Bank at December 31, 2014:

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**As of September 30, 2015**

**(Dollars in Thousands)**

|  | <b>Required Ratio</b> | <b>Actual Amount</b> | <b>Actual Ratio</b> |
|--|-----------------------|----------------------|---------------------|
| <b>Tier 1 Leverage Capital</b>                     |                       |                      |                     |
| Territorial Savings Bank (1)                       | 9.00%                 | \$ 217,621           | 12.41%              |
| Territorial Bancorp Inc.                           | 5.00%                 | \$ 223,694           | 12.75%              |
| <b>Common Equity Tier 1 Risk-Based Capital (2)</b> |                       |                      |                     |
| Territorial Savings Bank                           | 9.00%                 | \$ 217,621           | 27.32%              |
| Territorial Bancorp Inc.                           | 9.00%                 | \$ 223,694           | 28.07%              |
| <b>Tier 1 Risk-Based Capital (2)</b>               |                       |                      |                     |
| Territorial Savings Bank                           | 10.50%                | \$ 217,621           | 27.32%              |
| Territorial Bancorp Inc.                           | 10.50%                | \$ 223,694           | 28.07%              |
| <b>Total Risk-Based Capital (2)</b>                |                       |                      |                     |
| Territorial Savings Bank                           | 12.50%                | \$ 219,789           | 27.59%              |
| Territorial Bancorp Inc.                           | 12.50%                | \$ 225,862           | 28.34%              |

(1) As a condition of membership in the Federal Reserve System, Territorial Savings Bank is required to maintain a Tier 1 Leverage Capital ratio of 9.00% for three years beginning on July 10, 2014.

(2) The required Common Equity Tier 1 Risk-Based Capital, Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios are based on the fully-phased in capital ratios in the Basel III capital regulations plus the 2.50% capital conservation buffer that becomes effective on January 1, 2019.

**As of December 31, 2014**

**(Dollars in Thousands)**

|                                  | <b>Required Ratio</b> | <b>Actual Amount</b> | <b>Actual Ratio</b> |
|----------------------------------|-----------------------|----------------------|---------------------|
| <b>Tier 1 Leverage Capital</b>   |                       |                      |                     |
| Territorial Savings Bank (1)     | 9.00%                 | \$ 203,708           | 12.10%              |
| <b>Tier 1 Risk-Based Capital</b> |                       |                      |                     |
| Territorial Savings Bank         | 4.00%                 | \$ 203,708           | 29.68%              |
| <b>Total Risk-Based Capital</b>  |                       |                      |                     |
| Territorial Savings Bank         | 8.00%                 | \$ 205,403           | 29.93%              |

(1) As a condition of membership in the Federal Reserve System, Territorial Savings Bank is required to maintain a Tier 1 Leverage Capital ratio of 9.00% for three years beginning on July 10, 2014.



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**Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

*Commitments.* As a financial services provider, we routinely are a party to various financial instruments with off-balance sheet risks, such as commitments to extend credit and unused lines of credit. While these contractual obligations represent our potential future cash requirements, a significant portion of commitments to extend credit may expire without being drawn upon. Such commitments are subject to the same credit policies and approval process accorded to loans we make. In addition, we enter into commitments to sell mortgage loans.

*Contractual Obligations.* In the ordinary course of our operations, we enter into certain contractual obligations. Such obligations include operating leases for premises and equipment, agreements with respect to borrowed funds and deposit liabilities and agreements with respect to investments. Except for an increase of \$32.0 million in borrowings, an increase of \$13.6 million in certificates of deposit and an increase of \$4.2 million in loan commitments between December 31, 2014 and September 30, 2015, there have not been any material changes in contractual obligations and funding needs since December 31, 2014.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

*General.* Our most significant form of market risk is interest rate risk because, as a financial institution, the majority of our assets and liabilities are sensitive to changes in interest rates. Therefore, a principal part of our operations is to manage interest rate risk and limit the exposure of our net interest income to changes in market interest rates. Our Board of Directors has established an Asset/Liability Management Committee, which is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate, given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the guidelines approved by the Board of Directors.

Because we have historically operated as a traditional thrift institution, the significant majority of our assets consist of long-term, fixed-rate residential mortgage loans and mortgage-backed securities, which we have funded primarily with checking and savings accounts and short-term borrowings. In addition, there is little demand for adjustable-rate mortgage loans in the Hawaii market area. This has resulted in our being particularly vulnerable to increases in interest rates, as our interest-bearing liabilities mature or reprice more quickly than our interest-earning assets.

Our policies do not permit hedging activities, such as engaging in futures, options or swap transactions, or investing in high-risk mortgage derivatives, such as collateralized mortgage obligation residual interests, real estate mortgage investment conduit residual interests or stripped mortgage-backed securities.

*Economic Value of Equity.* We use an interest rate sensitivity analysis that computes changes in the economic value of equity (EVE) of our cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. EVE represents the market value of portfolio equity and is equal to the present value of assets minus the present value of liabilities, with adjustments made for off-balance sheet items. This analysis assesses the risk of loss in market-risk-sensitive instruments in the event of an instantaneous and sustained 100 to 400 basis point increase or a 100 basis point decrease in market interest rates with no effect given to any steps that we might take to counter the effect of that interest rate movement. A basis point equals one-hundredth of one percent, and 100 basis points equals one percent. An increase in interest rates from 3% to 4% would mean, for example, a 100 basis point increase in the *Change in Interest Rates* column below. Given the current relatively low level of market interest rates, an EVE calculation for an interest rate decrease of greater than 100 basis points has not been prepared.

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The following table presents our internal calculations of the estimated changes in our EVE as of June 30, 2015 that would result from the designated instantaneous changes in the interest rate yield curve.

| Change in Interest Rates (bp) (1) | Estimated EVE (2) | Estimated Increase (Decrease) in EVE (Dollars in thousands) | Percentage Change in EVE | EVE Ratio as a Percent of Present Value of Assets (3)(4) | Increase (Decrease) in EVE Ratio as a Percent of Present Value of Assets (3)(4) |
|-----------------------------------|-------------------|---|--------------------------|--|---|
| +400                              | \$ 170,875        | \$ (73,462)   | (30.07)%                 | 10.11%   | (3.61)%   |
| +300                              | \$ 195,397        | \$ (48,940)   | (20.03)%                 | 11.37%   | (2.35)%   |
| +200                              | \$ 220,142        | \$ (24,195)   | (9.90)%                  | 12.59%   | (1.13)%   |
| +100                              | \$ 239,886        | \$ (4,451)  | (1.82)%                  | 13.54%   | (0.18)%   |
| 0                                 | \$ 244,337        | \$  | %                        | 13.72%   | %   |
| -100                              | \$ 218,942        | \$ (25,395)   | (10.39)%                 | 12.44%   | (1.28)%   |

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- (1) Assumes an instantaneous uniform change in interest rates at all maturities.
  - (2) EVE is the difference between the present value of an institution's assets and liabilities.
  - (3) Present value of assets represents the discounted present value of incoming cash flows on interest-earning assets.
  - (4) EVE Ratio represents EVE divided by the present value of assets.

Interest rates on mortgage-backed securities declined by approximately 26 basis points between June 30, 2015 and September 30, 2015. The decrease in interest rates has likely increased our EVE. However, we do not believe that the increase in EVE is material.

Certain shortcomings are inherent in the methodologies used in determining interest rate risk through changes in EVE. Modeling changes in EVE requires making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the EVE table presented assumes that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although the EVE table provides an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our EVE and net interest income and will differ from actual results.

#### **ITEM 4. CONTROLS AND PROCEDURES**

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Chief Financial Officer, of the effectiveness of the design and

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operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 30, 2015. Based on that evaluation, the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective.

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During the quarter ended September 30, 2015, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.



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**PART II**

**ITEM 1. LEGAL PROCEEDINGS**

The Company and its subsidiaries are subject to various legal actions that are considered ordinary, routine litigation incidental to the business of the Company, and no claim for money damages exceeds ten percent of the Company's consolidated assets. In the opinion of management, based on currently available information, the resolution of these legal actions is not expected to have a material adverse effect on the Company's results of operations.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors as previously disclosed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission for the period ended December 31, 2014.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

(a) Not applicable.

(b) Not applicable.

(c) Stock Repurchases. The following table sets forth information in connection with repurchases of our shares of common stock during the three months ended September 30, 2015.

| Period                                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs (1) |
|--|----------------------------------|------------------------------|--|--|
| July 1, 2015 through July 31, 2015     |                                  | \$                           |  | 150,000  |
| August 1, 2015 through August 31, 2015 | 59,192                           | 26.11                        | 34,945   | 115,055  |

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|  |         |          |         |        |
|--|---------|----------|---------|--------|
| September 1, 2015 through September 30, 2015 | 76,320  | 26.01    | 76,320  | 38,735 |
| Total  | 135,512 | \$ 26.05 | 111,265 | 38,735 |

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(1) On December 4, 2014, our Board of Directors authorized the repurchase of up to 400,000 shares of our common stock. The Company initially repurchased a total of 250,000 shares. Further repurchases were subject to the receipt of regulatory approvals or non-objections for the employee stock ownership plan to own 10% or more of the Company's outstanding shares of common stock. On July 1, 2015, the Company received the final regulatory approval needed for the ESOP to own more than 10% of the Company's common stock. In accordance with this authorization, we repurchased 361,265 shares of our common stock as of September 30, 2015. This repurchase authorization expires on February 17, 2016. We have entered into a Rule 10b5-1 plan with respect to our stock repurchase plan.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

The exhibits required by Item 601 of Regulation S-K are included with this Form 10-Q and are listed on the [Index to Exhibits](#) immediately following the Signatures.

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**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.

**TERRITORIAL BANCORP INC.**  
(Registrant)

Date: November 6, 2015

/s/ Allan S. Kitagawa  
Allan S. Kitagawa  
Chairman of the Board, President and  
Chief Executive Officer

Date: November 6, 2015

/s/ Melvin M. Miyamoto  
Melvin M. Miyamoto  
Senior Vice President and Chief Financial Officer

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**INDEX TO EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 31.1                      | Certification of Allan S. Kitagawa, Chairman of the Board, President and Chief Executive Officer, Pursuant to Rule 13a-14(a) and Rule 15d-14(a).   |
| 31.2                      | Certification of Melvin M. Miyamoto, Senior Vice President and Chief Financial Officer, Pursuant to Rule 13a-14(a) and Rule 15d-14(a).   |
| 32                        | Certification of Allan S. Kitagawa, Chairman of the Board, President and Chief Executive Officer, and Melvin M. Miyamoto, Senior Vice President and Chief 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                   | Interactive datafile XBRL Instance Document  |
| 101.SCH                   | Interactive datafile XBRL Taxonomy Extension Schema Document   |
| 101.CAL                   | Interactive datafile XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF                   | Interactive datafile XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB                   | Interactive datafile XBRL Taxonomy Extension Label Linkbase  |
| 101.PRE                   | Interactive datafile XBRL Taxonomy Extension Presentation Linkbase Document  |