

Territorial Bancorp Inc.  
Form 10-Q  
August 14, 2009  
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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 June 30, 2009

or

**.. 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, or 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.

12,233,125 shares of Common Stock, par value \$0.01 per share, were issued and outstanding as of August 10, 2009.

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**TERRITORIAL BANCORP INC.**

Form 10-Q Quarterly Report

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**EXPLANATORY NOTE**

Territorial Bancorp Inc., a Maryland corporation (the Registrant), headquartered in Honolulu, Hawaii, was formed to serve as the stock holding company for Territorial Savings Bank as part of the mutual-to-stock conversion of Territorial Mutual Holding Company (the MHC). As of June 30, 2009, the conversion had not been completed, and, as of that date, the Registrant had no assets or liabilities, and had not conducted any business other than that of an organizational nature. Accordingly, financial and other information of the MHC is included in this Quarterly Report.

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**ITEM 1. FINANCIAL STATEMENTS**  
**TERRITORIAL MUTUAL HOLDING COMPANY**  
**AND SUBSIDIARIES**

**Consolidated Balance Sheets (Unaudited)**

(Dollars in thousands)

|  | <b>June 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|--|--------------------------|------------------------------|
| <b>ASSETS</b>  |                          |                              |
| Cash and cash equivalents  | \$ 322,008               | \$ 11,216                    |
| Investment securities held to maturity, at amortized cost (fair value of \$516,221 and \$535,590 at June 30, 2009 and December 31, 2008, respectively) | 509,857                  | 527,767                      |
| Federal Home Loan Bank stock, at cost  | 12,348                   | 12,348                       |
| Loans held for sale  | 2,438                    |                              |
| Loans receivable, net  | 604,828                  | 633,160                      |
| Accrued interest receivable  | 4,607                    | 4,787                        |
| Premises and equipment, net  | 4,747                    | 4,444                        |
| Real estate owned  | 131                      | 131                          |
| Bank-owned life insurance  | 27,620                   | 27,107                       |
| Investment receivable  | 15,198                   |                              |
| Prepaid expenses and other assets  | 5,203                    | 3,486                        |
| <b>Total assets</b>  | <b>\$ 1,508,985</b>      | <b>\$ 1,224,446</b>          |
| <b>LIABILITIES AND EQUITY</b>  |                          |                              |
| <b>Liabilities</b>   |                          |                              |
| Deposits   | \$ 1,221,699             | \$ 923,914                   |
| Advances from the Federal Home Loan Bank   |                          | 35,791                       |
| Securities sold under agreements to repurchase   | 130,200                  | 115,200                      |
| Subordinated debentures  | 24,232                   | 24,221                       |
| Accounts payable and accrued expenses  | 22,833                   | 18,634                       |
| Current income taxes payable   | 520                      | 963                          |
| Deferred income taxes payable  | 2,434                    | 3,228                        |
| Advance payments by borrowers for taxes and insurance  | 2,820                    | 3,114                        |
| <b>Total liabilities</b>   | <b>1,404,738</b>         | <b>1,125,065</b>             |
| <b>Commitments and contingencies</b>   |                          |                              |
| <b>Equity</b>  |                          |                              |
| Retained earnings  | 107,347                  | 100,897                      |
| Accumulated other comprehensive loss   | (3,100)                  | (1,516)                      |
| <b>Total equity</b>  | <b>104,247</b>           | <b>99,381</b>                |

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|                              |              |              |
|------------------------------|--------------|--------------|
| Total liabilities and equity | \$ 1,508,985 | \$ 1,224,446 |
|------------------------------|--------------|--------------|

See accompanying notes to consolidated financial statements.

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**TERRITORIAL MUTUAL HOLDING COMPANY**  
**AND SUBSIDIARIES**

**Consolidated Statements Of Income (Unaudited)**

(Dollars in thousands)

|   | Three Months Ended<br>June 30, |               | Six Months Ended<br>June 30, |               |
|---|--------------------------------|---------------|------------------------------|---------------|
|   | 2009                           | 2008          | 2009                         | 2008          |
| <b>Interest and dividend income:</b>                                    |                                |               |                              |               |
| Investment securities   | \$ 5,957                       | \$ 6,465      | \$ 12,229                    | \$ 12,914     |
| Tax-exempt investment securities  |                                | 14            |                              | 112           |
| Dividends on Federal Home Loan Bank stock                               |                                | 43            |                              | 74            |
| Loans   | 8,984                          | 8,681         | 18,432                       | 17,038        |
| Other investments   | 23                             | 19            | 23                           | 24            |
| <b>Total interest and dividend income</b>                               | <b>14,964</b>                  | <b>15,222</b> | <b>30,684</b>                | <b>30,162</b> |
| <b>Interest expense:</b>  |                                |               |                              |               |
| Deposits  | 3,833                          | 4,725         | 7,627                        | 9,907         |
| Advances from the Federal Home Loan Bank                                |                                | 10            | 33                           | 321           |
| Securities sold under agreements to repurchase                          | 1,255                          | 1,157         | 2,469                        | 2,159         |
| Subordinated debentures and other borrowings                            | 283                            | 380           | 584                          | 916           |
| <b>Total interest expense</b>   | <b>5,371</b>                   | <b>6,272</b>  | <b>10,713</b>                | <b>13,303</b> |
| <b>Net interest income</b>  | <b>9,593</b>                   | <b>8,950</b>  | <b>19,971</b>                | <b>16,859</b> |
| <b>Provision for loan losses</b>  |                                | <b>(2)</b>    | <b>1,102</b>                 | <b>4</b>      |
| <b>Net interest income after provision for loan losses</b>              | <b>9,593</b>                   | <b>8,952</b>  | <b>18,869</b>                | <b>16,855</b> |
| <b>Noninterest income:</b>  |                                |               |                              |               |
| Total other-than-temporary impairment losses                            | (426)                          |               | (862)                        |               |
| Portion of loss recognized in other comprehensive income (before taxes) | (41)                           |               | 97                           |               |
| <b>Net other-than-temporary impairment losses</b>                       | <b>(467)</b>                   |               | <b>(765)</b>                 |               |
| Service fees on loan and deposit accounts                               | 650                            | 742           | 1,317                        | 1,464         |
| Income on bank-owned life insurance                                     | 258                            | 261           | 513                          | 522           |
| Gain on sale of investment securities                                   | 230                            | 68            | 230                          | 133           |
| Gain on sale of loans   | 378                            |               | 1,177                        |               |
| Other   | 68                             | 185           | 142                          | 297           |
| <b>Total noninterest income</b>   | <b>1,117</b>                   | <b>1,256</b>  | <b>2,614</b>                 | <b>2,416</b>  |
| <b>Noninterest expense:</b>   |                                |               |                              |               |
| Salaries and employee benefits  | 3,748                          | 3,758         | 7,545                        | 7,321         |
| Occupancy   | 1,098                          | 1,069         | 2,228                        | 2,087         |
| Equipment   | 764                            | 663           | 1,468                        | 1,364         |

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|   |              |              |               |               |
|---|--------------|--------------|---------------|---------------|
| Federal deposit insurance premiums        | 1,049        | 276          | 1,183         | 571           |
| Other general and administrative expenses | 704          | 813          | 1,574         | 1,565         |
| <b>Total noninterest expense</b>          | <b>7,363</b> | <b>6,579</b> | <b>13,998</b> | <b>12,908</b> |
| Income before income taxes                | 3,347        | 3,629        | 7,485         | 6,363         |
| <b>Income taxes</b>                       | <b>1,092</b> | <b>1,301</b> | <b>2,559</b>  | <b>2,222</b>  |
| Net income                                | \$ 2,255     | \$ 2,328     | \$ 4,926      | \$ 4,141      |

See accompanying notes to consolidated financial statements.

**Table of Contents****TERRITORIAL MUTUAL HOLDING COMPANY****AND SUBSIDIARIES****Consolidated Statements Of Equity And****Comprehensive Income (Unaudited)**

(Dollars in thousands)

|  | <b>Retained<br/>earnings</b> | <b>Accumulated<br/>other<br/>comprehensive<br/>income (loss)</b> | <b>Equity</b> |
|--|------------------------------|--|---------------|
| Balances at December 31, 2008  | \$ 100,897                   | (1,516)  | 99,381        |
| Cumulative effect from adoption of FSP FAS 115-2 and FAS 124-2, net of taxes of \$958  | 1,524                        | (1,524)  |               |
| Balances at December 31, 2008, as revised  | \$ 102,421                   | (3,040)  | 99,381        |
| Comprehensive income:  |                              |  |               |
| Net income   | 4,926                        |  | 4,926         |
| Other comprehensive loss, net of tax:  |                              |  |               |
| Investment securities:   |                              |  |               |
| Noncredit related losses on securities not expected to be sold, net of taxes of \$37   |                              | (60)   | (60)          |
| Total comprehensive income   |                              |  | 4,866         |
| Balances at June 30, 2009  | \$ 107,347                   | (3,100)  | 104,247       |
| Balances at December 31, 2007  | \$ 93,700                    | (1,221)  | 92,479        |
| Comprehensive income:  |                              |  |               |
| Net income   | 4,141                        |  | 4,141         |
| Other comprehensive loss, net of tax:  |                              |  |               |
| Retirement benefit plans   |                              |  |               |
| Less: Amortization of prior service credit and net losses recognized during the period in net periodic benefit cost net of taxes of \$23 |                              | 34   | 34            |
| Total comprehensive income   |                              |  | 4,175         |
| Balances at June 30, 2008  | \$ 97,841                    | (1,187)  | 96,654        |

See accompanying notes to consolidated financial statements.



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**TERRITORIAL MUTUAL HOLDING COMPANY**  
**AND SUBSIDIARIES**

**Consolidated Statements Of Cash Flows (Unaudited)**

(Dollars in thousands)

|   | <b>Six Months Ended<br/>June 30,</b> |                 |
|---|--------------------------------------|-----------------|
|   | <b>2009</b>                          | <b>2008</b>     |
| <b>Cash flows from operating activities:</b>  |                                      |                 |
| Net income  | \$ 4,926                             | 4,141           |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                      |                 |
| Provision for loan losses   | 1,102                                | 4               |
| Depreciation and amortization   | 472                                  | 521             |
| Deferred income tax (benefit) expense   | (757)                                | 150             |
| Amortization of fees, discounts, and premiums   | (587)                                | (194)           |
| Origination of loans held for sale  | (59,842)                             |                 |
| Proceeds from sales of loans held for sale  | 57,783                               |                 |
| Gain on sale of loans, net  | (379)                                |                 |
| Other-than-temporary impairment loss on investment  | 765                                  |                 |
| Gain on sale of investment securities   | (230)                                | (133)           |
| Net gain on sale of premises and equipment  | (3)                                  | (9)             |
| (Increase) decrease in accrued interest receivable  | 180                                  | (116)           |
| Net increase in bank-owned life insurance   | (513)                                | (522)           |
| Net increase in prepaid expenses and other assets   | (1,717)                              | (93)            |
| Net increase (decrease) in accounts payable and accrued expenses                            | 4,199                                | (637)           |
| Net increase (decrease) in federal and state income taxes, net                              | (443)                                | 458             |
| <b>Net cash provided by operating activities</b>  | <b>4,956</b>                         | <b>3,570</b>    |
| <b>Cash flows from investing activities:</b>  |                                      |                 |
| Purchases of investment securities held to maturity   | (42,824)                             | (31,688)        |
| Purchases of investment securities available for sale                                       | (14,967)                             | (8,764)         |
| Principal repayments on investment securities held to maturity                              | 59,641                               | 28,698          |
| Proceeds from sale of investment securities available for sale                              |                                      | 18,449          |
| Loan originations, net of principal repayments on loans receivable                          | 28,058                               | (49,065)        |
| Purchases of premises and equipment   | (775)                                | (355)           |
| Proceeds from disposals of premises and equipment   | 3                                    | 9               |
| <b>Net cash (used in) provided by investing activities</b>                                  | <b>29,136</b>                        | <b>(42,716)</b> |

(Continued)

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**TERRITORIAL MUTUAL HOLDING COMPANY**  
**AND SUBSIDIARIES**

**Consolidated Statements Of Cash Flows (Unaudited)**

(Dollars in thousands)

|  | Six Months Ended<br>June 30, |             |
|--|------------------------------|-------------|
|  | 2009                         | 2008        |
| <b>Cash flows from financing activities:</b>                                     |                              |             |
| Net increase in deposits   | \$ 297,785                   | 41,071      |
| Proceeds from advances from the Federal Home Loan Bank                           | 50,476                       | 256,719     |
| Repayments of advances from the Federal Home Loan Bank                           | (86,267)                     | (327,509)   |
| Proceeds from reverse repurchase agreements                                      | 15,000                       | 205,350     |
| Repayments of reverse repurchase agreements                                      |                              | (145,350)   |
| Purchases of Fed Funds   | 39,367                       | 241,733     |
| Sales of Fed Funds   | (39,367)                     | (241,733)   |
| Net decrease (increase) in advance payments by borrowers for taxes and insurance | (294)                        | 54          |
| <br>Net cash provided by financing activities                                    | <br>276,700                  | <br>30,335  |
| <br>Net (decrease) increase in cash and cash equivalents                         | <br>310,792                  | <br>(8,811) |
| Cash and cash equivalents at beginning of the period                             | 11,216                       | 19,755      |
| <br>Cash and cash equivalents at end of the period                               | <br>\$ 322,008               | <br>10,944  |
| <br>Supplemental disclosure of cash flow information:                            |                              |             |
| Cash paid for:   |                              |             |
| Interest on deposits and borrowings  | \$ 10,667                    | \$ 13,514   |
| Income taxes   | 3,759                        | 1,614       |
| Supplemental disclosure of noncash investing activities:                         |                              |             |
| Investments sold, not settled  | \$ 15,198                    |             |
| See accompanying notes to consolidated financial statements.                     |                              |             |

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**TERRITORIAL MUTUAL HOLDING COMPANY  
AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**(1) Basis of Presentation**

The accompanying unaudited consolidated financial statements of Territorial Mutual Holding Company (referred to herein as the Company, we, us, or our) 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 Territorial Bancorp Inc.'s Prospectus dated May 15, 2009, as filed with the Securities and Exchange Commission pursuant to Securities Act Rule 424(b)(3) on May 26, 2009. In the opinion of management, all adjustments necessary for a fair presentation have been made and include all normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year.

**(2) Recently Issued Accounting Pronouncements**

In February 2008, the Financial Accounting Standards Board (FASB) amended Statement of Financial Accounting Standards (SFAS) 157 through the issuance of FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*. FSP FAS 157-2 is effective upon issuance and delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, for nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company adopted the provisions of FSP FAS 157-2 on January 1, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)). SFAS 141(R) establishes principles and requirements for how the acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest (minority interest) in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination or a gain from a bargain purchase and determining what information should be disclosed to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Company adopted the provisions of SFAS 141(R) on January 1, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* (SFAS 160). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded

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disclosure requirements regarding the interests of the parent and its noncontrolling interest. The Company adopted the provisions of SFAS 160 on January 1, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how (a) an entity uses derivative instruments; (b) derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and (c) derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Specifically, SFAS 161 requires (1) disclosure of the objectives for using derivative instruments in terms of underlying risk and accounting designation; (2) disclosure of the fair values of derivative instruments and their gains and losses in a tabular format; (3) disclosure of information about credit-risk-related contingent features; and (4) cross-reference from the derivative note to other notes in which derivative-related information is disclosed. The Company adopted the provisions of SFAS 161 on January 1, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In June 2008, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 08-3, *Accounting by Lessees for Maintenance Deposits* (EITF 08-3). EITF 08-3 states that lessees shall account for nonrefundable maintenance deposits as a deposit asset if it is probable that the maintenance activities will occur and the deposit is realizable. The Company adopted the provisions of EITF 08-3 on January 1, 2009 and such adoption did not have any impact on its consolidated financial statements.

In April 2009, the FASB issued FSP FAS Nos. 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2 and FAS 124-2). This FSP amends the other-than-temporary impairment guidance in U.S. generally accepted accounting principles and disclosure requirements in the financial statements. For securities not expected to be sold, credit related other-than-temporary impairment is recognized in earnings while noncredit related impairment is recognized in other comprehensive income. FSP FAS 115-2 and FAS 124-2 is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company early adopted the provisions of FSP FAS 115-2 and FAS 124-2 on January 1, 2009. As a result, a \$1.5 million cumulative adjustment for prior year impairment losses was recorded that increased retained earnings and decreased accumulated other comprehensive income as of the beginning of the year.

In April 2009, the FASB issued FSP FAS No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased. It also includes guidance on identifying circumstances that indicate a transaction is not orderly. FSP FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company early adopted the provisions of FSP FAS 157-4 on January 1, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In April 2009, the FASB issued FSP FAS No. 107-1 and APB No. 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded

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companies as well as in annual financial statements. It also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods. FSP FAS 107-1 and APB 28-1 is effective for interim reporting periods ending after June 15, 2009. The Company adopted FSP FAS 107-1 and APB 28-1 on April 1, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165). SFAS 165 establishes general standards for the accounting and disclosure of events that occur after the balance sheet date but before the financial statements are issued or available to be issued. SFAS 165 is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted the provisions of SFAS 165 on June 30, 2009 and such adoption did not have a material impact on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140* (SFAS 166). SFAS 166 seeks to improve the usefulness of the information a company provides about a transfer of financial assets, the effects of the transfer on its financial position, performance and cash flows, and its continuing involvement in the transferred financial assets. SFAS 166 is effective as of the beginning of the first annual reporting period that ends after November 15, 2009. The Company is currently evaluating the impact of adopting SFAS 166 on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167). SFAS 167 seeks to improve financial reporting by enterprises involved with variable interest entities and also addresses the effects of SFAS 166 on certain provisions of SFAS 46(R). SFAS 167 is effective as of the beginning of the first annual reporting period that ends after November 15, 2009. The Company is currently evaluating the impact of adopting SFAS 167 on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification<sup>TM</sup> and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* (SFAS 168). SFAS 168 is effective for financial statements issued after September 15, 2009 and becomes the source of authoritative U.S. generally accepted accounting principles (GAAP) to be applied by nongovernmental entities. The pronouncement primarily impacts the way GAAP is referenced in financial statements and the Company does not expect the adoption of this statement to have any impact on its consolidated financial statements.

**(3) Cash and Cash Equivalents**

Cash and cash equivalents includes cash and due from banks, interest-bearing deposits in other banks, federal funds sold, and short-term, highly liquid investments with original maturities of three months or less. The table below presents the balances of cash and cash equivalents as of June 30, 2009 and December 31, 2008.

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| (Dollars in thousands)                   | June 30,<br>2009 | December 31,<br>2008 |
|--|------------------|----------------------|
| Cash and due from banks                  | \$ 11,370        | 10,136               |
| Interest-bearing deposits in other banks | 5,122            | 1,080                |
| Short-term investments                   | 305,516          |                      |
| <br>                                     |                  |                      |
| Cash and cash equivalents                | \$ 322,008       | 11,216               |

Short term investments rose by \$305.5 million primarily because of an increase in loan repayments and deposits. During the six-month period ending June 30, 2009, deposits grew by \$297.8 million. \$248.9 million of the increase in deposits represent orders of common stock in our subscription offering.

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**(4) Investment Securities**

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

| (Dollars in thousands)                               | Amortized<br>cost | Gross<br>unrealized<br>Gains | Losses         | Estimated<br>fair value |
|--|-------------------|------------------------------|----------------|-------------------------|
| <b>June 30, 2009:</b>                                |                   |                              |                |                         |
| Held to maturity:                                    |                   |                              |                |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 506,178        | 10,423                       | (924)          | \$ 515,677              |
| Trust preferred securities                           | 3,679             |                              | (3,135)        | 544                     |
| <b>Total</b>   | <b>\$ 509,857</b> | <b>10,423</b>                | <b>(4,059)</b> | <b>\$ 516,221</b>       |
| <b>December 31, 2008:</b>                            |                   |                              |                |                         |
| Held to maturity:                                    |                   |                              |                |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 523,228        | 10,617                       | (331)          | \$ 533,514              |
| Trust preferred securities                           | 4,539             |                              | (2,463)        | 2,076                   |
| <b>Total</b>   | <b>\$ 527,767</b> | <b>10,617</b>                | <b>(2,794)</b> | <b>\$ 535,590</b>       |

The amortized cost and estimated fair value of investment securities at June 30, 2009 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 |
|------------------------------------|-------------------|-------------------------|
| <b>Held to maturity:</b>           |                   |                         |
| Due after 1 year through 5 years   | \$ 5,858          | 5,918                   |
| Due after 5 years through 10 years | 24,658            | 25,389                  |
| Due after 10 years                 | 479,341           | 484,914                 |
| <b>Total</b>                       | <b>\$ 509,857</b> | <b>516,221</b>          |

Proceeds from sales of securities available for sale were \$15.2 million for the three months ended June 30, 2009, resulting in gross realized gains of \$230,000. Proceeds from sales of securities available for sale were \$5.0 million for the three months ended June 30, 2008, resulting in gross realized gains of \$61,000.

Proceeds from sales of securities available for sale were \$15.2 million for the six months ended June 30, 2009, resulting in gross realized gains of \$230,000. Proceeds from sales of securities available for sale were \$7.9 million for the six months ended June 30, 2008, resulting in gross realized gains of \$126,000.

The Company received proceeds of \$10.5 million from the sale of \$10.5 million of held-to-maturity municipal bonds during the three months ended June 30, 2008, resulting in gross realized gains and

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losses of \$81,000 and \$80,000, respectively. Approximately \$5.5 million of these securities experienced a credit downgrade. The remaining securities were sold because of concerns about a potential downgrade of the bond s insurers. There were no other sales of held-to-maturity securities during the six month periods ended June 30, 2009 and 2008.

Investment securities with carrying values of \$296.7 million at June 30, 2009 were pledged to secure public deposits, reverse repurchase agreements, and transaction clearing accounts.

Provided below is a summary of investment securities, which were in an unrealized loss position at June 30, 2009 and December 31, 2008. The Company has the ability to hold these securities until such time as the value recovers or the securities mature.

| Description of securities<br>(Dollars in thousands) | Less than 12 months |                   | 12 months or longer |                   | Number of securities | Total         |                   |
|---|---------------------|-------------------|---------------------|-------------------|----------------------|---------------|-------------------|
|   | Fair value          | Unrealized losses | Fair value          | Unrealized losses |                      | Fair value    | Unrealized losses |
| <b>June 30, 2009</b>                                |                     |                   |                     |                   |                      |               |                   |
| Mortgage-backed securities                          | \$ 69,323           | 908               | 405                 | 16                | 13                   | 69,728        | 924               |
| Trust preferred securities                          |                     |                   | 544                 | 3,135             | 2                    | 544           | 3,135             |
| <b>Total</b>  | <b>\$ 69,323</b>    | <b>908</b>        | <b>949</b>          | <b>3,151</b>      | <b>15</b>            | <b>70,272</b> | <b>4,059</b>      |
| <b>December 31, 2008:</b>                           |                     |                   |                     |                   |                      |               |                   |
| Mortgage-backed securities                          | \$ 7,423            | 7                 | 60,241              | 324               | 16                   | 67,664        | 331               |
| Trust preferred securities                          |                     |                   | 2,076               | 2,463             | 2                    | 2,076         | 2,463             |
| <b>Total</b>  | <b>\$ 7,423</b>     | <b>7</b>          | <b>62,317</b>       | <b>2,787</b>      | <b>18</b>            | <b>69,740</b> | <b>2,794</b>      |

**Trust Preferred Securities.** At June 30, 2009, the Company owned trust preferred securities with a carrying value of \$3.7 million. 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. All of these securities are classified in the Bank s held-to-maturity investment portfolio.

We review our securities investment portfolio on a quarterly basis for indications of impairment. On January 1, 2009, the Bank adopted FSP FAS 157-4, 115-2 and 124-2 which provide further guidance on whether a market for an asset is distressed or inactive, determining whether an entity has the intent and ability to hold a security to its anticipated recovery and whether an investment is other-than-temporarily impaired (OTTI). In accordance with the adoption of these new accounting statements, management has analyzed all investment securities which have an amortized cost that exceeds fair value as of June 30, 2009.

As of June 30, 2009 the amortized cost of the two trust preferred securities exceeded fair value. Our pooled trust preferred securities are beneficial interests in securitized financial assets within the scope of EITF 99-20 and are therefore evaluated for OTTI by discounting management s best estimate of future cash flows. The assumptions used in the discounted cash flow analysis included the following: a discount rate based on the current effective yield of each security, estimated deferral and default rates on collateral, and estimated cash flows. The discounted cash flow analysis included a review of all issuers within each collateral pool and incorporated higher deferral and default rates in the cash flow projections over the next two years with a forecast of lower deferral and default rates in later years.

The discounted cash flow analysis is considered our primary evidence in determining whether



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OTTI has occurred. If the present value of cash flows is less than amortized cost, OTTI has occurred. The difference between the present value of cash flows and amortized cost is considered a credit loss and is recorded through earnings. The amount of OTTI related to other factors is recorded in other comprehensive income.

The Company had previously considered its investment in PreTSL XXIV other-than-temporarily impaired as of March 31, 2009 and the Company recorded impairment charges of \$299,000 through March 31, 2009. Based on its continued review, the Company considered its investment in this security to have experienced additional OTTI as of June 30, 2009, and recorded an impairment charge of \$467,000, which was considered to be a credit loss recorded through the income statement.

In reviewing its investment in the second trust preferred security (PreTSL XXIII), the Company's discounted cash flow analysis indicated that it should be able to recover the entire amortized cost basis of the security. Accordingly, as of June 30, 2009, the Company did not consider its investment in the second trust preferred security to have experienced OTTI.

At June 30, 2009, PreTSL XXIII is rated CC while PreTSL XXIV is rated C.

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

**(Dollars in thousands)**

|  |            |
|--|------------|
| Balance, January 1, 2009   | \$ 1       |
| Credit losses on debt securities for which other-than-temporary impairment was not previously recognized |            |
| Credit losses on debt securities for which other-than-temporary impairment was previously recognized     | 765        |
| <br>Balance at June 30, 2009   | <br>\$ 766 |

**(5) Federal Home Loan Bank Stock**

The Company evaluated its investment in FHLB stock for other-than-temporary impairment as of June 30, 2009, consistent with its accounting policies. Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the actions being taken by the FHLB of Seattle to address its regulatory capital situation and the Company's intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an other-than-temporary impairment loss. Moody's Investor Service and Standard and Poor's Rating Services have affirmed the FHLB of Seattle's credit rating of Aaa and AA+/A1+, respectively. Standard and Poor's also removed the FHLB of Seattle from Credit Watch Negative. Even though the Company did not recognize an other-than-temporary impairment loss during the six-month period ending June 30, 2009, continued deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

**Table of Contents****(6) Loans Receivable**

The components of loans receivable at June 30, 2009 and December 31, 2008 are as follows:

| (Dollars in thousands)                | June 30,<br>2009  | December 31<br>2008 |
|---------------------------------------|-------------------|---------------------|
| Real estate loans:                    |                   |                     |
| First mortgages:                      |                   |                     |
| One- to-four family residential       | \$ 559,316        | 581,251             |
| Multifamily residential               | 3,702             | 3,756               |
| Construction, commercial, and other   | 19,227            | 21,042              |
| Home equity loans and lines of credit | 24,426            | 29,956              |
| <b>Total real estate loans</b>        | <b>606,671</b>    | <b>636,005</b>      |
| Other loans:                          |                   |                     |
| Loans on deposit accounts             | 1,373             | 1,305               |
| Consumer and other loans              | 5,539             | 4,792               |
| <b>Total other loans</b>              | <b>6,912</b>      | <b>6,097</b>        |
| Less:                                 |                   |                     |
| Net unearned fees and discounts       | (5,148)           | (5,100)             |
| Undisbursed loan funds                | (1,606)           | (2,943)             |
| Allowance for loan losses             | (2,001)           | (899)               |
|                                       | (8,755)           | (8,942)             |
|                                       | <b>\$ 604,828</b> | <b>633,160</b>      |

The Company had five impaired loans at June 30, 2009 amounting to \$1.0 million with specific reserves of \$103,000. There were no impaired loans at December 31, 2008.

The Company had five nonaccrual loans for \$1.0 million at June 30, 2009 and one nonaccrual loan for \$149,000 as of December 31, 2008. The Company did not collect or recognize any interest income on nonaccrual loans. The Company did not have any loans more than 90 days past due and still accruing interest as of June 30, 2009 or December 31, 2008.

The Company sold \$57.4 million of mortgage loans during the six months ended June 30, 2009 and recognized a gain of \$1.1 million. No loans were sold during the six months ended June 30, 2008.

The Company serviced loans for others of \$116.0 million at June 30, 2009 and \$63.2 million at December 31, 2008. Of these amounts, \$11.9 million and \$12.7 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at June 30, 2009 and December 31, 2008. The amount of contractually specified servicing fees earned for the six-month periods ended June 30, 2009 and June 30, 2008 was \$145,000 and \$125,000, respectively. The amount of contractually specified servicing fees earned for the three-month periods ended June 30, 2009 and June 30, 2008 was \$84,000 and \$61,000, respectively. The fees are reported in service fees on loan and deposit accounts in the consolidated statements of income.

**Table of Contents****(7) Allowance for Loan Losses**

The activity in the allowance for loan losses on loans receivable is as follows:

| (Dollars in thousands)       | Three Months Ended<br>June 30, |      | Six Months Ended<br>June 30, |      |
|------------------------------|--------------------------------|------|------------------------------|------|
|                              | 2009                           | 2008 | 2009                         | 2008 |
| Balance, beginning of period | \$ 2,001                       | 769  | \$ 899                       | 768  |
| Provision                    |                                | (2)  | 1,102                        | 4    |
|                              | 2,001                          | 767  | 2,001                        | 772  |
| Charge-offs                  | (2)                            | (1)  | (3)                          | (7)  |
| Recoveries                   | 2                              | 3    | 3                            | 4    |
| Net charge-offs              |                                | 2    |                              | (3)  |
| Balance, end of period       | \$ 2,001                       | 769  | \$ 2,001                     | 769  |

**(8) Mortgage Servicing Assets**

Mortgage servicing assets are created when the Company sells mortgage loans and retains the rights to service the loans. Mortgage servicing assets are accounted for using SFAS 156, *Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140*, and are initially valued at fair value and subsequently at the lower of cost or fair value. We amortize mortgage servicing rights in proportion to and over the period of estimated net servicing income. All servicing rights are included in a single class. Mortgage servicing assets related to loan sales are recorded as a gain on sale of loans and totaled \$310,000 and \$725,000 for the three and six months ended June 30, 2009, respectively, and \$0 for both the three and six months ended June 30, 2008.

The table below presents the changes in our mortgage servicing assets for the six months ended June 30, 2009:

| (Dollars in thousands)         | June 30,<br>2009 |
|--------------------------------|------------------|
| Balance at beginning of period | \$ 376           |
| Additions                      | 725              |
| Amortization                   | (54)             |
| Balance at end of period       | \$ 1,047         |

The valuation of new servicing assets is obtained from a cash flow model prepared by an independent third-party appraiser. The valuation reports prepared by the third-party are also used to assess impairment of servicing assets. Critical assumptions used in the discounted cash flow model include mortgage prepayment speeds, discount rates, cost of servicing and ancillary income.

Prepayment speed may be affected by economic factors such as home price appreciation, market interest rates, the availability of other loan products to our borrowers and customer payment patterns. Prepayment speeds include the impact of all borrower prepayments, including full payoffs, additional principal payments and the impact of loans paid off due to foreclosure liquidations. As market interest rates decline, prepayment speeds will generally increase as customers refinance existing mortgage loans

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under more favorable interest rate terms. As prepayment speeds increase, anticipated cash flows will generally decline resulting in a potential reduction, or impairment, to the fair value of the mortgage servicing assets. Alternatively, an increase in market interest rates may cause a decrease in prepayment speeds and therefore an increase in the fair value of mortgage servicing assets.

The table below presents the fair value and key assumptions used in determining the fair value of our mortgage servicing assets:

| (Dollars in thousands)  | June 30,<br>2009 | December 31,<br>2008 |
|---|------------------|----------------------|
| Fair value, beginning of period   | \$ 382           | 472                  |
| Fair value, end of period   | 1,106            | 382                  |
| Weighted average discount rate  | 10.00%           | 10.00%               |
| Weighted average prepayment speed assumption (PSA prepayment speed)   | 130.9 PSA        | 125.9 PSA            |
| The PSA prepayment model assumes increasing prepayment rates for the first 30 months of a loan's term and constant prepayment rates thereafter. |                  |                      |

**(9) Interest Rate Lock and Forward Loan Sale Commitments**

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 in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. They are recorded at their fair values in prepaid expenses and other assets or in accounts payable and accrued expenses. Changes in fair value are recorded in current earnings. At June 30, 2009, interest rate locks and forward loan sale commitments on loans held for sale amounted to \$4.7 million and \$7.2 million, respectively.

The table below presents the location of assets and liabilities related to derivatives.

| (Dollars in thousands)  | Location on Balance Sheet  | Asset Derivatives                 |                                       | Liability Derivatives             |                                       |
|-------------------------|--|-----------------------------------|---------------------------------------|-----------------------------------|---------------------------------------|
|                         |  | Fair Value at<br>June 30,<br>2009 | Fair Value at<br>December 31,<br>2008 | Fair Value at<br>June 30,<br>2009 | Fair Value at<br>December 31,<br>2008 |
| Interest rate contracts | Prepaid expenses and other assets/ Accounts payable and accrued expenses | \$ 120                            |                                       | 48                                |                                       |
| Total derivatives       |  | \$ 120                            |                                       | 48                                |                                       |

The table below presents the location of gains and losses related to derivatives.

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| (Dollars in thousands)  | Location of gain (loss) on Statement of Income | Three Months Ended June 30, |      | Six Months Ended June 30, |      |
|-------------------------|--|-----------------------------|------|---------------------------|------|
|                         |  | 2009                        | 2008 | 2009                      | 2008 |
| Interest rate contracts | Gain on sale of loans                          | \$ (115)                    |      | 72                        |      |
| Total derivatives       |  | \$ (115)                    |      | 72                        |      |

**(10) Deposits**

Deposit accounts by type are summarized with their respective weighted average interest rates as follows:

| (Dollars in thousands)                            | June 30, 2009 |       | December 31, 2008 |       |
|---|---------------|-------|-------------------|-------|
|   | Amount        | Rate  | Amount            | Rate  |
| Noninterest bearing                               | \$ 14,090     | %     | \$ 14,965         | %     |
| Savings accounts                                  | 504,848       | 1.69% | 407,252           | 1.59% |
| Certificates of deposit with an original term of: |               |       |                   |       |
| 3 months  | 4,655         | 0.74  | 8,323             | 1.74  |
| 6 months  | 44,346        | 1.26  | 81,600            | 2.37  |
| 9 months  | 3,316         | 1.20  | 26,197            | 2.63  |
| 1 year  | 133,136       | 2.68  | 129,810           | 2.93  |
| 2 years   | 22,816        | 3.03  | 18,705            | 3.28  |
| 3 years   | 6,747         | 3.11  | 2,833             | 3.55  |
| 4 years   | 962           | 3.54  | 576               | 3.73  |
| 5 years and above                                 | 14,426        | 3.56  | 11,169            | 3.55  |
| Jumbo   | 123,425       | 0.58  | 117,956           | 1.56  |
|   | 353,829       |       | 397,169           |       |
| Money market                                      | 329,227       | 0.92  | 84,763            | 0.06  |
| Checking and Super NOW                            | 19,705        | 0.06  | 19,765            | 0.06  |
|   | \$ 1,221,699  | 1.47  | \$ 923,914        | 1.74  |

The maturity of certificate of deposit accounts is as follows (dollars in thousands):

|                                     |            |
|-------------------------------------|------------|
| Maturing in:                        |            |
| One year or less                    | \$ 313,720 |
| Over one year through two years     | 23,290     |
| Over two years through three years  | 7,210      |
| Over three years through four years | 2,275      |
| Over four years through five years  | 7,334      |
|                                     | \$ 353,829 |



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Certificates of deposit with balances greater than or equal to \$100,000 totaled \$181.7 million and \$185.2 million at June 30, 2009 and December 31, 2008, respectively. Accounts in the Bank are insured by the FDIC, generally up to a maximum of \$100,000 per separately insured depositor and up to a maximum of \$250,000 for self-directed retirement accounts. However, the FDIC increased the deposit insurance available on deposit accounts to \$250,000 per depositor effective until December 31, 2013.

At June 30, 2009 and December 31, 2008, overdrawn deposit accounts totaled \$119,000 and \$150,000, respectively, and have been reclassified as loans in the consolidated balance sheets.

**(11) 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 dollar amount of securities underlying the agreements remaining in the asset accounts. Securities sold under agreements to repurchase at June 30, 2009 and December 31, 2008 are summarized as follows:

| (Dollars in thousands)  | June 30, 2009           |                             | December 31, 2008       |                             |
|-------------------------|-------------------------|-----------------------------|-------------------------|-----------------------------|
|                         | Repurchase<br>liability | Weighted<br>average<br>rate | Repurchase<br>liability | Weighted<br>average<br>rate |
| <b>Maturing:</b>        |                         |                             |                         |                             |
| Within 1 year           | \$ 25,000               | 3.13%                       | \$                      | %                           |
| Over 1 year to 2 years  | 32,000                  | 3.11                        | 25,000                  | 3.13                        |
| Over 2 years to 3 years | 14,900                  | 4.38                        | 43,900                  | 3.53                        |
| Over 3 years to 4 years | 40,300                  | 4.12                        | 28,300                  | 4.75                        |
| Over 4 years to 5 years | 18,000                  | 4.87                        | 18,000                  | 4.87                        |
| Over 5 years            |                         |                             |                         |                             |
|                         | \$ 130,200              | 3.82%                       | \$ 115,200              | 3.95%                       |

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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 June 30, 2009. The amount at risk is the greater of the carrying value or fair value over the repurchase liability. All the agreements to repurchase are with JP Morgan Chase Bank and the securities pledged are issued and guaranteed by U.S. government-sponsored enterprises.

| (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 |
|------------------------|------------------------------------|--------------------------------|-------------------------|-------------------|--|
| Maturing:              |                                    |                                |                         |                   |  |
| Over 90 days           | \$ 148,810                         | 152,245                        | 130,200                 | 22,045            | 29   |
|                        | \$ 148,810                         | 152,245                        | 130,200                 | 22,045            | 29   |

**(12) Employee Benefit Plans**

The Company has a noncontributory defined benefit pension plan (Pension Plan) that covers substantially all 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.

In addition, the Company 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 defined pension plan.



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The components of net periodic benefit cost were as follows:

| (Dollars in thousands)                   | Pension benefits   |       | SERP |      |
|--|--------------------|-------|------|------|
|  | Three Months Ended |       |      |      |
|  | June 30,           |       |      |      |
|  | 2009               | 2008  | 2009 | 2008 |
| Net periodic benefit cost for the period |                    |       |      |      |
| Service cost                             | \$                 | 149   | 134  | 127  |
| Interest cost                            |                    | 147   | 77   | 67   |
| Expected return on plan assets           |                    | (177) |      |      |
| Amortization of prior service cost       |                    |       |      |      |
| Recognized actuarial loss                |                    | 28    |      |      |
| Recognized curtailment loss              |                    |       |      |      |
| Net periodic benefit cost                | \$                 | 147   | 211  | 194  |

| (Dollars in thousands)                   | Pension benefits          |       | SERP |      |
|--|---------------------------|-------|------|------|
|  | Six Months Ended June 30, |       |      |      |
|  | 2009                      | 2008  | 2009 | 2008 |
| Net periodic benefit cost for the period |                           |       |      |      |
| Service cost                             | \$                        | 298   | 268  | 255  |
| Interest cost                            |                           | 294   | 154  | 134  |
| Expected return on plan assets           |                           | (353) |      |      |
| Amortization of prior service cost       |                           | 1     |      |      |
| Recognized actuarial loss                |                           | 55    |      |      |
| Recognized curtailment loss              |                           |       |      |      |
| Net periodic benefit cost                | \$                        | 295   | 422  | 389  |

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

SFAS 157, *Fair Value Measurements*, defines fair value and the methods used for measuring fair value as well as requiring additional disclosures. FASB Staff Position FAS 157-2, *Effective Date of FASB Statement No. 157*, delayed the effective date of SFAS 157 to January 1, 2009 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FASB also issued Staff Position FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* in October 2008, which clarified the application of SFAS 157 in a market that is not active. FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* was issued in April 2009 and provides guidelines for making fair value measurements more consistent with the principles presented in SFAS 157 when the volume and level of activity for assets or liabilities have significantly decreased. We early adopted FSP FAS 157-4 on January 1, 2009.

Under SFAS 157, the Company groups its financial assets and liabilities 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.

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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.

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.

Under SFAS 157, the Company bases its fair values on the price that it would expect to receive if an asset were sold or pay to transfer a liability in an orderly transaction between market participants at the measurement date. As required under SFAS 157, the Company maximizes the use of observable inputs and minimizes the use of unobservable inputs when developing fair value measurements.

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, Accrued Interest 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 fair values for investment securities were based on quoted market prices, if available, and were classified as Level 1. The estimated fair value of U.S. government-sponsored mortgage-backed securities are considered to be Level 1 inputs. If quoted market prices were not available, the valuation for investment securities utilized pricing models that varied based on asset class and included trade, bid and other observable market information. Securities priced using this information were classified as Level 2.

Our pooled trust preferred securities are collateralized debt obligations secured by trust preferred securities issued primarily by banks and bank holding companies in the United States. Since there has been no active trading in these markets for the past nine months, fair value was determined by considering a range of fair value estimates provided by a pricing service and using a discounted cash flow analysis prepared by management. The primary difference between the fair value estimate prepared by our pricing service and our discounted cash flow analysis is the discount rate. As of June 30, 2009, we utilized the yield on similarly rated trust preferred securities issued by banks plus a credit and liquidity premium of 2.00% to arrive at a risk-adjusted discount rate of 14.51%. Our pricing service used a discount rate of 21.00% for PreTSL XXIII and 22.00% for PreTSL XXIV. The pricing service provided fair value estimates of \$10.25 for PreTSL XXIII and \$1.04 for PreTSL XXIV.

The assumptions used by management in the discounted cash flow analysis included the following: estimated discount rates based on yields of comparably traded instruments adjusted for illiquidity and other risk factors, estimated deferral and default rates on collateral, and estimated cash flows. The

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discounted cash flow analysis included a review of all issuers within each collateral pool and incorporated higher deferral and default rates in the cash flow projections over the next two years and a forecast of lower deferral and default rates in later years.

Management considered the range of fair value estimates and decided that our pricing service's estimate of fair value should be assigned a 70% weight and our discounted cash flow estimate should be assigned a 30% weight. We gave a greater weighting to the fair value estimate of our pricing service because of their experience in these matters as an independent third-party service provider. The fair value estimates provided by the pricing service and management's discounted cash flow analysis resulted in a weighted fair value estimate of \$11.50 for PreTSL XXIII and \$3.93 for PreTSL XXIV. 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.

***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.

***Short-Term Investments.*** The fair value of short-term investments is estimated by discounting the future cash flows using the rates currently offered for investments of similar remaining maturities.

***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 of 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 of similar remaining maturities.

***Subordinated Debentures.*** Fair value is estimated by discounting future cash flows using the rates currently offered to the Company for debt of similar remaining maturities adjusted for nonperformance, credit, and liquidity risks.

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

| (Dollars in thousands)                                | June 30, 2009   |                      | December 31, 2008 |                      |
|---|-----------------|----------------------|-------------------|----------------------|
|   | Carrying amount | Estimated fair value | Carrying amount   | Estimated fair value |
| <b>Assets</b>   |                 |                      |                   |                      |
| Cash  | \$ 16,492       | 16,492               | 11,216            | 11,216               |
| Short-term investments                                | 305,516         | 305,517              |                   |                      |
| Investment securities held to maturity                | 509,857         | 516,221              | 527,767           | 535,590              |
| FHLB stock  | 12,348          | 12,348               | 12,348            | 12,348               |
| Loans held for sale                                   | 2,438           | 2,460                |                   |                      |
| Loans receivable, net                                 | 604,828         | 613,615              | 633,160           | 641,427              |
| Accrued interest receivable                           | 4,607           | 4,607                | 4,787             | 4,787                |
| <b>Liabilities</b>                                    |                 |                      |                   |                      |
| Deposits  | \$ 1,221,699    | 1,224,496            | 923,914           | 925,951              |
| Advances from the FHLB                                |                 |                      | 35,791            | 35,798               |
| Securities sold under agreements to repurchase        | 130,200         | 134,896              | 115,200           | 119,860              |
| Subordinated debentures                               | 24,232          | 7,315                | 24,221            | 7,918                |
| Accounts payable and accrued expenses                 | 22,833          | 22,833               | 18,634            | 18,634               |
| Current income taxes payable                          | 520             | 520                  | 963               | 963                  |
| Advance payments by borrowers for taxes and insurance | 2,820           | 2,820                | 3,114             | 3,114                |

At June 30, 2009 and December 31, 2008, neither the commitment fees received on commitments to extend credit nor the fair value thereof was significant to the consolidated financial statements of the Company.

The table below presents the balance of assets measured at fair value on a recurring basis as of June 30, 2009. There were no assets or liabilities measured at fair value as of December 31, 2008.

| (Dollars in thousands)       | Level 1 | Level 2 | Level 3 | Total |
|------------------------------|---------|---------|---------|-------|
| Interest rate contracts, net | \$      | 72      |         | 72    |

The table below presents the balance of assets measured at fair value on a nonrecurring basis as of June 30, 2009 and December 31, 2008.

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| (Dollars in thousands)     | Level 1 | Level 2 | Level 3 | Total |
|----------------------------|---------|---------|---------|-------|
| June 30, 2009              |         |         |         |       |
| Delinquent loan            | \$      | 312     |         | 312   |
| Trust preferred securities |         |         | 137     | 137   |
| December 31, 2008          |         |         |         |       |
| Trust preferred securities | \$      |         | 998     | 998   |

**(14) Subsequent Events**

Subsequent events have been evaluated through August 14, 2009, the issue date of the financial statements.

On July 10, 2009, the Company completed its plan of conversion and reorganization from a mutual holding company to a stock holding company. In accordance with the plan, Territorial Mutual Holding Company and Territorial Savings Group ceased to exist as separate legal entities and a stock holding company, Territorial Bancorp Inc. (of which Territorial Savings Bank became a wholly-owned subsidiary) issued and sold shares of capital stock to eligible depositors and borrowers of Territorial Savings Bank. A total of 12,233,125 shares were issued in the conversion at \$10 per share, raising \$122.3 million of gross proceeds. Approximately \$3.6 million of conversion expenses have been offset against the gross proceeds. Territorial Bancorp Inc.'s common stock began trading on the NASDAQ Global Select Market under the symbol **TBNK** on July 13, 2009.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**Cautionary Statement Regarding Forward-Looking Information**

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.

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 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;



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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.

**Critical Accounting Policies**

There are no material changes to the critical accounting policies disclosed in Territorial Bancorp Inc.'s Prospectus dated May 15, 2009, as filed with the Securities and Exchange Commission pursuant to Securities Act Rule 424(b)(3) on May 26, 2009.

**Comparison of Financial Condition at June 30, 2009 and December 31, 2008**

**Assets.** At June 30, 2009, our assets were \$1.509 billion, an increase of \$284.5 million, or 23.2%, from \$1.224 billion at December 31, 2008. The increase was caused by an increase in cash and cash equivalents, partially offset by decreases in loans and investment securities held to maturity.

**Cash and Cash Equivalents.** Cash and cash equivalents were \$322.0 million at June 30, 2009 compared to \$11.2 million at December 31, 2008. The increase resulted from the receipt of funds for the purchase of shares of common stock in our stock offering, which did not close until July 10, 2009. We received orders for approximately \$284.4 million of shares of common stock in our subscription offering. Of the total subscription orders received, \$248.9 million of payments came from new funds deposited and \$35.5 million came from existing deposits. The increase in cash and cash equivalents also resulted from repayments of investment securities held to maturity and loan repayments and prepayments exceeding the cash we needed to fund loan originations and other operations.

**Loans.** At June 30, 2009, total loans (including loans held for sale of \$2.4 million) were \$616.0 million, or 40.8% of total assets. During the six months ended June 30, 2009, the loan portfolio decreased \$26.1 million, or 4.1%. The decrease was caused primarily by a decrease in one- to four-family residential real estate loans of \$19.5 million, as we sold \$58.2 million of longer-term loans during the six months ended June 30, 2009. Home equity loans and lines of credit also decreased by \$5.5 million.

**Securities.** At June 30, 2009, our securities portfolio totaled \$509.9 million, or 33.8% of assets. At June 30, 2009, 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 loans having less than full documentation) loans. At June 30, 2009, we held no common or preferred stock of Fannie Mae or Freddie Mac.



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During the six months ended June 30, 2009, our securities portfolio decreased \$17.9 million, or 3.4%, as repayments exceeded purchases of securities.

At June 30, 2009, we owned trust preferred securities with a carrying value of \$3.7 million. This portfolio consists of two securities (PreTSL XXIII and PreTSL XXIV), which represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. At June 30, 2009, these securities were graded CC and C, respectively.

On April 9, 2009, the Financial Accounting Standards Board issued Financial Accounting Standards Board Staff Position ( FSP ) No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, and FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments. FSP FAS 115-2 and FAS 124-2 amends the other-than-temporary impairment guidance for U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in a company's financial statements. Before these recent staff positions, to conclude that an impairment was not other than temporary an entity was required, among other considerations, to assert that it had the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value in accordance with Securities and Exchange Commission Staff Accounting Bulletin Topic 5M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities, and other authoritative literature. As a result of these recent staff positions, an entity should assess whether the entity (a) has the intent to sell the debt security or (b) more likely than not will be required to sell the debt security before its anticipated recovery (for example, if its cash or working capital requirements or contractual or regulatory obligations indicate that the debt security will be required to be sold before the forecasted recovery occurs). FSP FAS 115-2 and FAS 124-2 also changes the trigger used to assess the collectibility of cash flows from probable that the investor will be unable to collect all amounts due to the entity does not expect to recover the entire amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, an other-than-temporary impairment shall have occurred. We adopted FSP FAS 157-4 and FSP FAS 115-2 and FAS 124-2 for the quarter ended March 31, 2009.

In reviewing our investment in the trust preferred securities, we concluded that we did not have the intent to sell either trust preferred security, and it was not more likely than not that we would be required to sell either trust preferred security before the anticipated recovery.

The trust preferred securities market is considered to be inactive as only two sales transactions of similarly rated securities have occurred over the past 12 months. In addition, there have been no new issues of pooled trust preferred securities since 2007. Because the trust preferred securities market is inactive, we use a discounted cash flow model to determine the estimated fair value of the trust preferred securities and to determine whether they are other-than-temporarily impaired.

We had previously considered our investment in PreTSL XXIV other-than-temporarily impaired as of December 31, 2008, and we recorded a \$2.5 million impairment charge during the quarter ended December 31, 2008. Based on our continued review, we considered our investment in this security to have experienced additional other-than-temporary impairment as of March 31, 2009 and June 30, 2009, and recorded an additional \$862,000 impairment charge with respect to this security during the six months ended June 30, 2009, of which \$765,000 was a credit loss recorded through our income statement as a debit to non-interest income, and \$97,000 was recorded as an increase to other comprehensive loss. In addition, the cumulative effect of our adoption of FSP FAS 157-4 and FSP FAS 115-2 and FAS 124-2, effective March 31, 2009, resulted in the reclassification of \$1.5 million, net of tax of \$958,000, of securities impairment from retained earnings to accumulated other comprehensive loss.

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In reviewing our investment in the second trust preferred security (PreTSL XXIII), our discounted cash flow analysis indicated that we should be able to recover the entire amortized cost basis of the security. Accordingly, as of June 30, 2009, we did not consider our investment in the second trust preferred security to have experienced other-than-temporary impairment.

We own common stock of the Federal Home Loan Bank of Seattle with an aggregate cost and fair value as of June 30, 2009 of \$12.3 million based on its par value. There is no market for our Federal Home Loan Bank of Seattle common stock. In May 2009, the FHLB of Seattle reported a net loss for the first quarter of 2009 and continued to have a risk-based capital deficiency. Moody's Investor Service and Standard and Poor's Rating Services have affirmed the FHLB of Seattle's credit rating of Aaa and AA+/A1+, respectively. Standard and Poor's also removed the FHLB of Seattle from Credit Watch Negative.

Recent published reports indicate that certain member banks of the Federal Home Loan Bank System may be subject to accounting rules and asset quality risks that could result in materially lower regulatory capital levels. In an extreme situation, it is possible that the capital of a Federal Home Loan Bank, including the Federal Home Loan Bank of Seattle, could be substantially diminished or reduced to zero. In addition, the Federal Home Loan Bank of Seattle stopped paying dividends during the fourth quarter of 2008.

**Deposits.** During the six months ended June 30, 2009, our deposits grew \$297.8 million, or 32.2%. The increase resulted from the receipt of funds for the purchase of shares of common stock in our stock offering, which did not close until July 10, 2009. We received orders for approximately \$284.4 million of shares of common stock in our subscription offering. Of the total subscription orders received, \$248.9 million of payments came from new funds deposited and \$35.5 million came from existing deposits. The increase was also caused by our continuing to promote higher than market rates for our savings accounts (which increased \$97.6 million during the six-month period), offsetting a decrease of \$43.3 million in certificates of deposit. During the six months ended June 30, 2009, we continued to lower the rates we pay on certificates of deposit because of increased liquidity from other sources, such as principal repayments on loans and mortgage-backed securities, allowing these deposits to run off.

**Borrowings.** Historically, our borrowings consisted primarily of advances from the Federal Home Loan Bank of Seattle and funds borrowed under repurchase agreements. During the six months ended June 30, 2009, our borrowings decreased \$20.8 million, or 13.8%. During the quarter ended March 31, 2009, we repaid all of our outstanding Federal Home Loan Bank advances, and our reverse repurchase agreements increased \$15.0 million, or 13.0%. We did not require further borrowings to fund our operations. Instead, we funded our operations with additional deposits and principal repayments on loans and mortgage-backed securities.

**Equity.** At June 30, 2009, our equity was \$104.2 million, an increase of \$4.9 million, or 4.9%, from \$99.4 million at December 31, 2008. The increase resulted from net income of \$4.9 million for the six months ended June 30, 2009.

## **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

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thereof was not material. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances, but have been reflected in the tables 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 June 30, |          |                    |                                   |          |                    |
|--|-------------------------------------|----------|--------------------|-----------------------------------|----------|--------------------|
|  | 2009                                |          |                    | 2008                              |          |                    |
|  | 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                      | \$ 561,074                          | \$ 8,098 | 5.77%              | \$ 539,886                        | \$ 7,642 | 5.66%              |
| Multi-family residential                             | 3,720                               | 66       | 7.10               | 4,361                             | 78       | 7.15               |
| Construction, commercial and other                   | 18,494                              | 292      | 6.32               | 20,063                            | 347      | 6.92               |
| Home equity loans and lines of credit                | 25,296                              | 417      | 6.59               | 28,566                            | 497      | 6.96               |
| Other loans  | 6,594                               | 111      | 6.73               | 6,480                             | 117      | 7.22               |
| Total loans  | 615,178                             | 8,984    | 5.84               | 599,356                           | 8,681    | 5.79               |
| Investment securities:                               |                                     |          |                    |                                   |          |                    |
| U.S. government sponsored mortgage-backed securities | 498,388                             | 5,957    | 4.78               | 520,159                           | 6,368    | 4.90               |
| Municipal bonds                                      |                                     |          |                    | 1,622                             | 14       | 3.45               |
| Trust preferred securities                           | 4,099                               |          |                    | 7,065                             | 87       | 4.93               |
| Other  |                                     |          |                    | 1,846                             | 10       | 2.17               |
| Total securities                                     | 502,487                             | 5,957    | 4.74               | 530,692                           | 6,479    | 4.88               |
| Other  | 101,178                             | 23       | 0.09               | 16,633                            | 62       | 1.49               |
| Total interest-earning assets                        | 1,218,843                           | 14,964   | 4.91               | 1,146,681                         | 15,222   | 5.31               |
| Non-interest-earning assets                          | 61,724                              |          |                    | 49,958                            |          |                    |
| Total assets   | \$ 1,280,567                        |          |                    | \$ 1,196,639                      |          |                    |
| <b>Interest-bearing liabilities:</b>                 |                                     |          |                    |                                   |          |                    |
| Savings accounts                                     | \$ 468,878                          | \$ 1,947 | 1.66%              | \$ 402,162                        | \$ 1,547 | 1.54%              |
| Certificates of deposit                              | 370,816                             | 1,756    | 1.89               | 406,052                           | 3,162    | 3.11               |
| Money market accounts                                | 116,914                             | 127      | 0.43               | 83,978                            | 12       | 0.06               |
| Checking and Super NOW accounts                      | 19,967                              | 3        | 0.06               | 21,105                            | 4        | 0.08               |
| Total interest-bearing deposit                       | 976,575                             | 3,833    | 1.57               | 913,297                           | 4,725    | 2.07               |
| Federal Home Loan Bank advances                      |                                     |          |                    | 1,203                             | 10       | 3.33               |
| Other borrowings                                     | 154,429                             | 1,538    | 3.98               | 141,798                           | 1,537    | 4.34               |
| Total interest-bearing liabilities                   | 1,131,004                           | 5,371    | 1.90               | 1,056,298                         | 6,272    | 2.38               |
| Non-interest-bearing liabilities                     | 45,145                              |          |                    | 43,408                            |          |                    |
| Total liabilities                                    | 1,176,149                           |          |                    | 1,099,706                         |          |                    |
| Equity   | 104,418                             |          |                    | 96,933                            |          |                    |
| Total liabilities and equity                         | \$ 1,280,567                        |          |                    | \$ 1,196,639                      |          |                    |
| Net interest income                                  |                                     | \$ 9,593 |                    |                                   | \$ 8,950 |                    |
| Net interest rate spread (2)                         |                                     |          | 3.01%              |                                   |          | 2.93%              |
| Net interest-earning assets (3)                      | \$ 87,839                           |          |                    | \$ 90,383                         |          |                    |
| Net interest margin (4)                              |                                     |          | 3.15%              |                                   |          | 3.12%              |

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|  |         |         |
|--|---------|---------|
| Average of interest-earning assets to interest-bearing liabilities | 107.77% | 108.56% |
|--|---------|---------|

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

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|  | For the Six Months Ended June 30, |           |                    |                                   |           |                    |
|--|-----------------------------------|-----------|--------------------|-----------------------------------|-----------|--------------------|
|  | 2009                              |           |                    | 2008                              |           |                    |
|  | 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                      | \$ 570,886                        | \$ 16,607 | 5.82%              | \$ 527,027                        | \$ 14,992 | 5.69%              |
| Multi-family residential                             | 3,731                             | 133       | 7.13               | 4,402                             | 158       | 7.18               |
| Construction, commercial and other                   | 18,239                            | 583       | 6.39               | 19,046                            | 668       | 7.01               |
| Home equity loans and lines of credit                | 26,835                            | 896       | 6.68               | 28,194                            | 985       | 6.99               |
| Other loans  | 6,384                             | 213       | 6.67               | 6,479                             | 235       | 7.25               |
| Total loans  | 626,075                           | 18,432    | 5.89               | 585,148                           | 17,038    | 5.82               |
| Investment securities:                               |                                   |           |                    |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities | 507,094                           | 12,237    | 4.83               | 519,884                           | 12,695    | 4.88               |
| Municipal bonds                                      |                                   |           |                    | 6,034                             | 112       | 3.71               |
| Trust preferred securities                           | 3,894                             | (8)       | (0.41)             | 7,069                             | 209       | 5.91               |
| Other  |                                   |           |                    | 923                               | 10        | 2.17               |
| Total securities                                     | 510,988                           | 12,229    | 4.79               | 533,910                           | 13,026    | 4.88               |
| Other  | 58,000                            | 23        | 0.08               | 15,219                            | 98        | 1.29               |
| Total interest-earning assets                        | 1,195,063                         | 30,684    | 5.14               | 1,134,277                         | 30,162    | 5.32               |
| Non-interest-earning assets                          | 57,614                            |           |                    | 50,469                            |           |                    |
| Total assets   | \$ 1,252,677                      |           |                    | \$ 1,184,746                      |           |                    |
| <b>Interest-bearing liabilities:</b>                 |                                   |           |                    |                                   |           |                    |
| Savings accounts                                     | \$ 446,953                        | \$ 3,648  | 1.63%              | \$ 390,665                        | \$ 2,955  | 1.51%              |
| Certificates of deposit                              | 378,688                           | 3,834     | 2.02               | 401,428                           | 6,921     | 3.45               |
| Money market accounts                                | 98,236                            | 140       | 0.29               | 82,985                            | 25        | 0.06               |
| Checking and Super NOW accounts                      | 19,883                            | 5         | 0.05               | 20,976                            | 6         | 0.06               |
| Total interest-bearing deposits                      | 943,760                           | 7,627     | 1.62               | 896,054                           | 9,907     | 2.21               |
| Federal Home Loan Bank advances                      | 7,900                             | 33        | 0.84               | 16,615                            | 321       | 3.86               |
| Other borrowings                                     | 152,705                           | 3,053     | 4.00               | 133,023                           | 3,075     | 4.62               |
| Total interest-bearing liabilities                   | 1,104,365                         | 10,713    | 1.94               | 1,045,692                         | 13,303    | 2.54               |
| Non-interest-bearing liabilities                     | 45,482                            |           |                    | 43,533                            |           |                    |
| Total liabilities                                    | 1,149,847                         |           |                    | 1,089,225                         |           |                    |
| Equity   | 102,830                           |           |                    | 95,521                            |           |                    |
| Total liabilities and equity                         | \$ 1,252,677                      |           |                    | \$ 1,184,746                      |           |                    |
| Net interest income                                  |                                   | \$ 19,971 |                    |                                   | \$ 16,859 |                    |
| Net interest rate spread (2)                         |                                   |           | 3.20%              |                                   |           | 2.78%              |
| Net interest-earning assets (3)                      | \$ 90,698                         |           |                    | \$ 88,585                         |           |                    |
| Net interest margin (4)                              |                                   |           | 3.34%              |                                   |           | 2.97%              |

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|  |         |         |
|--|---------|---------|
| Average of interest-earning assets to interest-bearing liabilities | 108.21% | 108.47% |
|--|---------|---------|

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

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**Table of Contents****Comparison of Operating Results for the Three Months Ended June 30, 2009 and 2008**

**General.** Net income decreased \$73,000 to \$2.26 million for the three months ended June 30, 2009 from \$2.33 million for the three months ended June 30, 2008. The decrease was primarily caused by an increase in non-interest expense of \$784,000, offset by an increase in net interest income of \$643,000.

**Net Interest Income.** Net interest income increased \$643,000, or 7.2%, to \$9.6 million for the three months ended June 30, 2009 from \$9.0 million for the three months ended June 30, 2008. Interest expense decreased \$901,000, or 14.4%, as declining market interest rates for certificates of deposit allowed us to reduce our deposit expense by \$892,000. Interest and dividend income decreased \$258,000, or 1.7%, as our average balance of investment securities decreased by \$28.2 million, or 5.3%, and the average yield we earned on investment securities decreased 14 basis points to 4.74% for the three months ended June 30, 2009 compared to 4.88% for the three months ended June 30, 2008. The interest rate spread and net interest margin were 3.01% and 3.15%, respectively, for the three months ended June 30, 2009, compared to 2.93% and 3.12% for the three months ended June 30, 2008.

**Interest and Dividend Income.** Interest and dividend income decreased \$258,000, or 1.7%, to \$15.0 million for the three months ended June 30, 2009 from \$15.2 million for the three months ended June 30, 2008. A decrease in interest income on securities was partially offset by an increase in interest income on loans. Interest income on securities decreased \$522,000, or 8.1%, to \$6.0 million for the three months ended June 30, 2009 from \$6.5 million for the three months ended June 30, 2008, as our average balance of investment securities decreased \$28.2 million, or 5.3%, and the yield we earned on investment securities decreased 14 basis points to 4.74% for the three months ended June 30, 2009 compared to 4.88% for the three months ended June 30, 2008. The reduction in our average securities portfolio was caused primarily by repayments on mortgage-backed securities exceeding new purchases. Interest income on loans increased \$303,000, or 3.5%, to \$9.0 million for the three months ended June 30, 2009 from \$8.7 million for the three months ended June 30, 2008, as our average balance of loans increased \$15.8 million, or 2.6%. There were no material changes in the rates we earned on loans between the periods.

**Interest Expense.** Interest expense decreased \$901,000, or 14.4%, to \$5.4 million for the three months ended June 30, 2009 from \$6.3 million for the three months ended June 30, 2008. Interest expense on deposits decreased \$892,000, or 18.9%, caused by a decrease in interest expense on certificates of deposit of \$1.4 million, or 44.5%. The rates we paid on certificates of deposit decreased 122 basis points, and we experienced a \$35.2 million, or 8.7%, decrease in the average balance of certificates of deposit. We have lowered the rates we pay on certificates of deposit because of increased liquidity from other sources, such as principal repayments on loans and mortgage-backed securities, allowing these deposits to run off. However, interest expense on passbook and statement savings accounts increased \$400,000, or 25.9%, to \$1.9 million for the three months ended June 30, 2009 from \$1.5 million for the three months ended June 30, 2008. The average balance of these deposits increased \$66.7 million, or 16.6%, to \$468.9 million for the three months ended June 30, 2009 from \$402.2 million for the three months ended June 30, 2008, and the average rate we paid on these deposits increased 12 basis points to 1.66% for the three months ended June 30, 2009 compared to 1.54% for the three months ended June 30, 2008. The increases were caused by our continuing to promote higher than market rates for our savings accounts. Interest expense on borrowings was virtually unchanged during the periods, as an increase in the average balance of other borrowings (primarily repurchase agreements) was offset by a decrease in the rate we paid on these borrowings.



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**Provision for Loan Losses.** We recorded no provision for loan losses for the three months ended June 30, 2009 compared to a \$2,000 reversal of allowance for the three months ended June 30, 2008. Non-performing loans totaled \$956,000 at June 30, 2009, or 0.16% of total loans at that date, compared to \$149,000 of non-performing loans at December 31, 2008, \$186,000 of non-performing loans at June 30, 2008 and \$106,000 of non-performing loans at December 31, 2007. Non-performing loans as of June 30, 2009 consisted primarily of one- to four-family residential real estate loans. We experienced net recoveries of \$0 and \$2,000 for the three months ended June 30, 2009 and 2008, respectively. The allowance for loan losses to total loans was 0.33% and 0.13% at June 30, 2009 and 2008, respectively. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at June 30, 2009 and 2008.

**Non-Interest Income.** The following table summarizes changes in non-interest income between the three months ended June 30, 2009 and 2008.

|  | Three Months Ended<br>June 30, |                 | Change          |                |
|--|--------------------------------|-----------------|-----------------|----------------|
|  | 2009                           | 2008            | \$ Change       | % Change       |
|  | (In thousands)                 |                 |                 |                |
| Other-than-temporary impairment loss on investments, net | \$ (467)                       | \$              | \$ (467)        | N/A            |
| Service fees on loan and deposit accounts                | 650                            | 742             | (92)            | (12.4)%        |
| Income on bank-owned life insurance                      | 258                            | 261             | (3)             | (1.1)%         |
| Gain on sale of investment securities                    | 230                            | 68              | 162             | 238.2%         |
| Gain on sale of loans                                    | 378                            |                 | 378             | N/A            |
| Other  | 68                             | 185             | (117)           | (63.2)%        |
| <b>Total</b>   | <b>\$ 1,117</b>                | <b>\$ 1,256</b> | <b>\$ (139)</b> | <b>(11.1)%</b> |

We sold \$33.6 million and \$0 of loans during the three months ended June 30, 2009 and 2008, respectively, and \$14.9 million and \$15.5 million of securities during the three months ended June 30, 2009 and 2008, respectively. We recognized a \$467,000 loss for other-than-temporary impairment on our investments in trust preferred securities in the second quarter of 2009, as described in Comparison of Financial Condition at June 30, 2009 and December 31, 2008 Securities.

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**Non-Interest Expense.** The following table summarizes changes in non-interest expense between the three months ended June 30, 2009 and 2008.

|                                    | Three Months Ended<br>June 30, |          | Change    |          |
|------------------------------------|--------------------------------|----------|-----------|----------|
|                                    | 2009                           | 2008     | \$ Change | % Change |
|                                    | (In thousands)                 |          |           |          |
| Salaries and employee benefits     | \$ 3,748                       | \$ 3,758 | \$ (10)   | (0.3)%   |
| Occupancy                          | 1,098                          | 1,069    | 29        | 2.7%     |
| Equipment                          | 764                            | 663      | 101       | 15.2%    |
| Federal deposit insurance premiums | 1,049                          | 276      | 773       | 280.1%   |
| Other                              | 704                            | 813      | (109)     | 13.4%    |
| Total                              | \$ 7,363                       | \$ 6,579 | \$ 784    | 11.9%    |

Federal deposit insurance premiums increased as a result of a special one-time premium imposed on all Federal Deposit Insurance Corporation insured financial institutions, as well as an increase in the regular premium rate.

**Income Tax Expense.** Income taxes were \$1.1 million for the three months ended June 30, 2009, reflecting an effective tax rate of 32.6% compared to \$1.3 million for the three months ended June 30, 2008, reflecting an effective tax rate of 35.9%. The decrease in the effective tax rate for the three months ended June 30, 2009 is due to a decline in taxes provided on deferred tax assets.

**Comparison of Operating Results for the Six Months Ended June 30, 2009 and 2008**

**General.** Net income increased \$785,000 to \$4.9 million for the six months ended June 30, 2009 from \$4.1 million for the six months ended June 30, 2008. The increase was caused primarily by a decrease in interest expense of \$2.6 million, partially offset by an increase in non-interest expense of \$1.1 million.

**Net Interest Income.** Net interest income increased \$3.1 million, or 18.5%, to \$20.0 million for the six months ended June 30, 2009 from \$16.9 million for the six months ended June 30, 2008. Interest expense decreased \$2.6 million, or 19.5%, as declining market interest rates for certificates of deposit allowed us to reduce our deposit expense by \$2.3 million. Interest and dividend income increased \$522,000, or 1.7%, as our average balance of loans increased by \$40.9 million, or 7.0%, and the average yield we earned on loans increased seven basis points to 5.89% for the six months ended June 30, 2009 compared to 5.82% for the six months ended June 30, 2008. The interest rate spread and net interest margin were 3.20% and 3.34%, respectively, for the six months ended June 30, 2009, compared to 2.78% and 2.97% for the six months ended June 30, 2008. The improvement in the interest rate spread was the result of a decrease in the average cost of interest-bearing liabilities of 60 basis points, partially offset by a decrease in the average yield on interest-earning assets of 18 basis points.

**Interest and Dividend Income.** Interest and dividend income increased \$522,000, or 1.7%, to \$30.7 million for the six months ended June 30, 2009 from \$30.2 million for the six months ended June 30, 2008. An increase in interest income on loans was partially offset by a decrease in interest income on securities. Interest income on loans increased \$1.4 million, or 8.2%, to \$18.4 million for the six months ended June 30, 2009 from \$17.0 million for the six months ended June 30, 2008, as our average balance of loans increased \$40.9 million, or 7.0%. The average balance of loans increased because all loan production for 2008 was retained in our portfolio. The average yield we earned on loans increased seven basis points to 5.89% for the six months ended June 30, 2009 compared to 5.82% for the six months

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ended June 30, 2008. Interest income on securities decreased \$797,000, or 6.1%, to \$12.2 million for the six months ended June 30, 2009 from \$13.0 million for the six months ended June 30, 2008, as our average balance of investment securities decreased \$22.9 million, or 4.3%, and the yield we earned on investment securities decreased nine basis points to 4.79% for the six months ended June 30, 2009 compared to 4.88% for the six months ended June 30, 2008. The reduction in our average securities portfolio was caused primarily by repayments on mortgage-backed securities exceeding new purchases.

**Interest Expense.** Interest expense decreased \$2.6 million, or 19.5%, to \$10.7 million for the six months ended June 30, 2009 from \$13.3 million for the six months ended June 30, 2008. Interest expense on deposits decreased \$2.3 million, or 23.0%, caused by a decrease in interest expense on certificates of deposit of \$3.1 million, or 44.6%. The rates we paid on certificates of deposit decreased 143 basis points, and we experienced a \$22.7 million, or 5.7%, decrease in the average balance of certificates of deposit. During the six months ended June 30, 2009, we continued to lower the rates we pay on certificates of deposit because of increased liquidity from other sources, such as principal repayments on loans and mortgage-backed securities, allowing these deposits to run off. However, interest expense on passbook and statement savings accounts increased \$693,000, or 23.5%, to \$3.6 million for the six months ended June 30, 2009 from \$3.0 million for the six months ended June 30, 2008. The average balance of these deposits increased \$56.3 million, or 14.4%, to \$447.0 million for the six months ended June 30, 2009 from \$390.7 million for the six months ended June 30, 2008, and the average rate we paid on these deposits increased 12 basis points to 1.63% for the six months ended June 30, 2009 compared to 1.51% for the six months ended June 30, 2008. The increases were caused by our continuing to promote higher than market rates for our savings accounts. Interest expense on borrowings decreased \$310,000, or 9.1%, resulting from our repaying all of our Federal Home Loan Bank advances during the quarter ended March 31, 2009.

**Provision for Loan Losses.** We recorded provisions for loan losses of \$1.1 million and \$4,000 for the six months ended June 30, 2009 and 2008, respectively. The provisions made during 2009 were general and specific reserves for one- to four-family residential real estate loans in recognition of increased non-performing loans and deteriorating environmental factors. Non-performing loans totaled \$956,000 at June 30, 2009, or 0.16% of total loans at that date, compared to \$149,000 of non-performing loans at December 31, 2008, \$186,000 of non-performing loans at June 30, 2008 and \$106,000 of non-performing loans at December 31, 2007. Non-performing loans as of June 30, 2009 consisted primarily of one- to four-family residential real estate loans. We experienced net recoveries of \$0 and \$3,000 for the six months ended June 30, 2009 and 2008, respectively. The allowance for loan losses to total loans was 0.33% and 0.13% at June 30, 2009 and 2008, respectively. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at June 30, 2009 and 2008.

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**Non-Interest Income.** The following table summarizes changes in non-interest income between the six months ended June 30, 2009 and 2008.

|  | Six Months Ended<br>June 30, |                 | Change        |             |
|--|------------------------------|-----------------|---------------|-------------|
|  | 2009                         | 2008            | \$ Change     | % Change    |
|  | (In thousands)               |                 |               |             |
| Other-than-temporary impairment loss on investments, net | \$ (765)                     | \$              | \$ (765)      | N/A         |
| Service fees on loan and deposit accounts                | 1,317                        | 1,464           | (147)         | (10.0)%     |
| Income on bank-owned life insurance                      | 513                          | 522             | (9)           | (1.7)%      |
| Gain on sale of investment securities                    | 230                          | 133             | 97            | 72.9%       |
| Gain on sale of loans                                    | 1,177                        |                 | 1,177         | N/A         |
| Other  | 142                          | 297             | (155)         | (52.2)%     |
| <b>Total</b>   | <b>\$ 2,614</b>              | <b>\$ 2,416</b> | <b>\$ 198</b> | <b>8.2%</b> |

We sold \$58.2 million and \$0 of loans during the six months ended June 30, 2009 and 2008, respectively, and \$14.9 million and \$18.3 of securities during the six months ended June 30, 2009 and 2008, respectively. During the six months ended June 30, 2009, we recognized a \$862,000 impairment charge with respect to our investments in trust preferred securities, of which \$765,000 was a credit loss recorded through our income statement as a debit to non-interest income, and \$97,000 was recorded as an increase to other comprehensive loss. See Comparison of Financial Condition at June 30, 2009 and December 31, 2008 Securities.

**Non-Interest Expense.** The following table summarizes changes in non-interest expense between the six months ended June 30, 2009 and 2008.

|                                    | Six Months Ended<br>June 30, |                  | Change          |             |
|------------------------------------|------------------------------|------------------|-----------------|-------------|
|                                    | 2009                         | 2008             | \$ Change       | % Change    |
|                                    | (In thousands)               |                  |                 |             |
| Salaries and employee benefits     | \$ 7,545                     | \$ 7,321         | \$ 224          | 3.1%        |
| Occupancy                          | 2,228                        | 2,087            | 141             | 6.8%        |
| Equipment                          | 1,468                        | 1,364            | 104             | 7.6%        |
| Federal deposit insurance premiums | 1,183                        | 571              | 612             | 107.2%      |
| Other                              | 1,574                        | 1,565            | 9               | 0.6%        |
| <b>Total</b>                       | <b>\$ 13,998</b>             | <b>\$ 12,908</b> | <b>\$ 1,090</b> | <b>8.4%</b> |

Federal deposit insurance premiums increased as a result of a special one-time premium imposed on all Federal Deposit Insurance Corporation insured financial institutions, as well as an increase in the regular premium rate.

**Income Tax Expense.** Income taxes were \$2.6 million for the six months ended June 30, 2009, reflecting an effective tax rate of 34.2% compared to \$2.2 million for the six months ended June 30, 2008, reflecting an effective tax rate of 34.9%.

**Table of Contents****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.

**Net Portfolio Value.** The Office of Thrift Supervision requires the computation of amounts by which the difference between the present value of an institution's assets and liabilities (the institution's net portfolio value or NPV) would change in the event of a range of assumed changes in market interest rates. The Office of Thrift Supervision provides all institutions that file a Consolidated Maturity/Rate Schedule as a part of their quarterly Thrift Financial Report with a report that measures the sensitivity of net portfolio value. The Office of Thrift Supervision simulation model uses a discounted cash flow analysis and an option-based pricing approach to measure the interest rate sensitivity of net portfolio value. Historically, the Office of Thrift Supervision model estimated the economic value of each type of asset, liability and off-balance sheet contract using the current interest rate yield curve with instantaneous increases or decreases of 100 to 300 basis points in 100 basis point increments. 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 NPV calculation for an interest rate decrease of greater than 100 basis points has not been prepared. The Office of Thrift Supervision provides us the results of the interest rate sensitivity model, which is based on information we provide to the Office of Thrift Supervision to estimate the sensitivity of our net portfolio value.

The table below sets forth, as of March 31, 2009, the Office of Thrift Supervision's calculation of the estimated changes in our net portfolio value that would result from the designated instantaneous changes in the interest rate yield curve. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results. We believe there has been no material change in our interest rate risk position as of June 30, 2009.

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| Change in Interest Rates (bp) (1) | Estimated NPV (2) | Estimated Increase (Decrease) in NPV | Percentage Change in NPV | NPV Ratio as a Percent of Present Value of Assets (3)(4) | Increase (Decrease) in NPV Ratio as a Percent of Present value of Assets (3)(4) |
|-----------------------------------|-------------------|--------------------------------------|--------------------------|--|---|
| +300                              | \$ 137,581        | \$ (58,294)                          | (29.76)%                 | 11.17%   | (3.86)%   |
| +200                              | \$ 167,426        | \$ (28,449)                          | (14.52)%                 | 13.22%   | (1.80)%   |
| +100                              | \$ 189,854        | \$ (6,021)                           | (3.07)%                  | 14.68%   | (.34)%  |
| 0                                 | \$ 195,875        |                                      |                          | 15.02%   |   |
| (100)                             | \$ 191,395        | \$ (4,480)                           | (2.29)%                  | 14.68%   | (.35)%  |

- (1) Assumes an instantaneous uniform change in interest rates at all maturities.  
(2) NPV 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) NPV Ratio represents NPV divided by the present value of assets.

The table above indicates that at March 31, 2009, in the event of a 200 basis point increase in interest rates, we would experience a 14.52% decrease in net portfolio value. In the event of a 100 basis point decrease in interest rates, we would experience a 2.29% decrease in net portfolio value.

In addition to the Office of Thrift Supervision's calculations with respect to the effects of changes in interest rates on net portfolio value, we prepare our own internal calculations, which utilizes a single interest rate scenario and prepayment assumption in calculating the market value of fixed- and adjustable-rate loans (compared to the Office of Thrift Supervision model, which uses an option-based pricing methodology). Our model also calculates the average life and value for core deposit intangibles that is based on a core deposit study we completed in 2006, whereas the Office of Thrift Supervision model uses a nationwide study to estimate the average life and value for core deposit intangibles. The following table presents our internal calculations of the estimated changes in our net portfolio value that would result from the designated instantaneous changes in the interest rate yield curve as of March 31, 2009. We believe there has been no material change in our interest rate risk position as of June 30, 2009.

| Change in Interest Rates (bp) (1) | Estimated NPV (2) | Estimated Increase (Decrease) in NPV | Percentage Change in NPV | NPV Ratio as a Percent of Present Value of Assets (3)(4) | Increase (Decrease) in NPV Ratio as a Percent of Present value of Assets (3)(4) |
|-----------------------------------|-------------------|--------------------------------------|--------------------------|--|---|
| +300                              | \$ 125,047        | \$ (42,300)                          | (25.28)%                 | 10.28%   | (2.87)%   |
| +200                              | \$ 148,389        | \$ (18,958)                          | (11.33)%                 | 11.92%   | (1.22)%   |
| +100                              | \$ 167,974        | \$ 627                               | .37%                     | 13.24%   | .09%  |
| 0                                 | \$ 167,347        |                                      |                          | 13.15%   |   |
| (100)                             | \$ 140,234        | \$ (27,113)                          | (16.20)%                 | 11.21%   | (1.94)%   |

- (1) Assumes an instantaneous uniform change in interest rates at all maturities.  
(2) NPV 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) NPV Ratio represents NPV divided by the present value of assets.

Certain shortcomings are inherent in the methodologies used in determining interest rate risk through changes in net portfolio value. Modeling changes in net portfolio value require 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 net portfolio value tables presented assume that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains

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constant over the period being measured and assume 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 net portfolio value tables provide 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 net portfolio value and will differ from actual results.

**ITEM 4. CONTROLS AND PROCEDURES**

Not applicable.

**ITEM 4T. 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 Treasurer, of the effectiveness of the design and 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 June 30, 2009. 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 Treasurer, concluded that the Company's disclosure controls and procedures were effective.

During the quarter ended June 30, 2009, 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**

In addition to the other information contained in this Quarterly Report on Form 10-Q, the following risk factors represent material updates and additions to the risk factors previously disclosed in the Company's Prospectus, as filed with the Securities and Exchange Commission pursuant to Rule 424(b)(3) of the Securities Act of 1933, as amended. Additional risks not presently known to us, or that we currently deem immaterial, may also adversely affect our business, financial condition or results of operations. Further, to the extent that any of the information contained in this Quarterly Report on Form 10-Q constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

**Any Future FDIC Insurance Premiums Will Adversely Impact Our Earnings.**

On May 22, 2009, the FDIC adopted a final rule levying a five basis point special assessment on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009. The special assessment is payable on September 30, 2009. We recorded an expense of \$689,000 during the quarter ended June 30, 2009, to reflect the special assessment. The final rule permits the FDIC's Board of Directors to levy up to two additional special assessments of up to five basis points each during 2009 if the FDIC estimates that the Deposit Insurance Fund reserve ratio will fall to a level that the FDIC's Board of Directors believes would adversely affect public confidence or to a level that will be close to or below zero. The FDIC has publicly announced that it is probable that it will levy an additional special assessment of up to five basis points later in 2009, the amount and timing of which are currently uncertain. Any further special assessments that the FDIC levies will be recorded as an expense during the appropriate period. In addition, the FDIC materially increased the general assessment rate and, therefore, our FDIC general insurance premium expense will increase substantially compared to prior periods.

**A Legislative Proposal Has Been Introduced That Would Eliminate our Primary Federal Regulator and Require Us to Convert to a National Bank or State Bank.**

The U.S. Treasury Department recently released a legislative proposal that would implement sweeping changes to the current bank regulatory structure. The proposal would create a new federal banking regulator, the National Bank Supervisor, and merge our current primary federal regulator, the Office of Thrift Supervision, as well as the Office of the Comptroller of the Currency (the primary federal regulator for national banks) into this new federal bank regulator. The proposal would also eliminate federal savings banks and require all federal savings banks, such as Territorial Savings Bank, to elect, within six months of the effective date of the legislation, to convert to either a national bank, state bank or state savings association. A federal savings association that does not make the election would, by operation of law, be converted into a national bank within one year of the effective date of the legislation. As of the date of this Quarterly Report on Form 10-Q, the legislative proposals contained in



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the Treasury white paper, including its proposal to eliminate the federal thrift charter, have not been formally considered by either house of the U.S. Congress. Accordingly, it is not clear whether the proposal to eliminate the federal thrift charter will become law.

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

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None

**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.

Date: August 14, 2009

Date: August 14, 2009

**TERRITORIAL BANCORP INC.**  
(Registrant)

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

/s/ Melvin M. Miyamoto  
Melvin M. Miyamoto  
Senior Vice President and Treasurer

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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 Treasurer, 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 Treasurer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |