

Territorial Bancorp Inc.  
Form 10-Q  
November 08, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period ended September 30, 2011**

**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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|   |                                       |
|---|---------------------------------------|
| <b>Maryland</b><br>(State or Other Jurisdiction)  | <b>26-4674701</b><br>(I.R.S. Employer |
| <b>of Incorporation)</b>  | <b>Identification No.)</b>            |
| <b>1132 Bishop Street, Suite 2200, Honolulu, Hawaii</b><br>(Address of Principal Executive Offices) | <b>96813</b><br>(Zip Code)            |
| <b>(808) 946-1400</b>   |                                       |

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.

11,044,031 shares of Common Stock, par value \$0.01 per share, were issued and outstanding as of October 31, 2011.

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**TERRITORIAL BANCORP INC.**

Form 10-Q Quarterly Report

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

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and cash equivalents   | \$ 132,448            | \$ 194,435           |
| Investment securities available for sale  | 0                     | 15,010               |
| Investment securities held to maturity, at amortized cost (fair value of \$694,996 and \$546,844 at September 30, 2011 and December 31, 2010, respectively)                     | 658,574               | 530,555              |
| Federal Home Loan Bank stock, at cost   | 12,348                | 12,348               |
| Loans held for sale   | 2,987                 | 3,234                |
| Loans receivable, net   | 662,734               | 641,790              |
| Accrued interest receivable   | 4,882                 | 4,536                |
| Premises and equipment, net   | 5,564                 | 5,426                |
| Real estate owned   | 162                   | 0                    |
| Bank-owned life insurance   | 29,991                | 29,266               |
| Deferred income taxes receivable  | 1,029                 | 22                   |
| Prepaid expenses and other assets   | 5,247                 | 6,790                |
| <br>  |                       |                      |
| Total assets  | \$ 1,515,966          | \$ 1,443,412         |
| <br>  |                       |                      |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                       |                      |
| <b>Liabilities</b>  |                       |                      |
| Deposits  | \$ 1,139,317          | \$ 1,076,470         |
| Advances from the Federal Home Loan Bank  | 20,000                | 10,000               |
| Securities sold under agreements to repurchase  | 120,200               | 105,200              |
| Accounts payable and accrued expenses   | 19,727                | 20,430               |
| Current income taxes payable  | 416                   | 577                  |
| Advance payments by borrowers for taxes and insurance   | 2,088                 | 3,376                |
| <br>  |                       |                      |
| Total liabilities   | 1,301,748             | 1,216,053            |
| <br>  |                       |                      |
| <b>Commitments and contingencies</b>  |                       |                      |
| <br>  |                       |                      |
| <b>Stockholders Equity</b>  |                       |                      |
| Preferred stock, \$.01 par value; authorized 50,000,000 shares, no shares issued or outstanding   | 0                     | 0                    |
| Common stock, \$.01 par value; authorized 100,000,000 shares; issued and outstanding 11,124,553 and 12,177,418 shares at September 30, 2011 and December 31, 2010, respectively | 111                   | 122                  |
| Additional paid-in capital  | 98,842                | 119,153              |
| Unearned ESOP shares  | (8,441)               | (8,808)              |
| Retained earnings   | 126,022               | 119,397              |
| Accumulated other comprehensive loss  | (2,316)               | (2,505)              |

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|  |              |              |
|--|--------------|--------------|
| Total stockholders' equity                 | 214,218      | 227,359      |
| Total liabilities and stockholders' equity | \$ 1,515,966 | \$ 1,443,412 |

See accompanying notes to consolidated financial statements.

**Table of Contents****TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Income (Unaudited)****(Dollars in thousands, except per share data)**

|   | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |                |
|---|-------------------------------------|---------------|------------------------------------|----------------|
|   | 2011                                | 2010          | 2011                               | 2010           |
| <b>Interest and dividend income:</b>                                    |                                     |               |                                    |                |
| Investment securities   | \$ 6,907                            | \$ 6,371      | \$ 20,167                          | \$ 19,819      |
| Loans   | 8,798                               | 8,907         | 26,444                             | 26,018         |
| Other investments   | 85                                  | 115           | 258                                | 290            |
| <b>Total interest and dividend income</b>                               | <b>15,790</b>                       | <b>15,393</b> | <b>46,869</b>                      | <b>46,127</b>  |
| <b>Interest expense:</b>  |                                     |               |                                    |                |
| Deposits  | 1,700                               | 2,555         | 5,109                              | 8,484          |
| Advances from the Federal Home Loan Bank                                | 105                                 | 54            | 295                                | 99             |
| Securities sold under agreements to repurchase                          | 1,067                               | 1,070         | 3,153                              | 3,211          |
| <b>Total interest expense</b>   | <b>2,872</b>                        | <b>3,679</b>  | <b>8,557</b>                       | <b>11,794</b>  |
| <b>Net interest income</b>  | <b>12,918</b>                       | <b>11,714</b> | <b>38,312</b>                      | <b>34,333</b>  |
| Provision (reversal of allowance) for loan losses                       | (39)                                | 118           | 83                                 | 276            |
| <b>Net interest income after provision for loan losses</b>              | <b>12,957</b>                       | <b>11,596</b> | <b>38,229</b>                      | <b>34,057</b>  |
| <b>Non-interest income:</b>   |                                     |               |                                    |                |
| Total other-than-temporary impairment losses                            | 0                                   | 0             | 0                                  | (3,510)        |
| Portion of loss recognized in other comprehensive income (before taxes) | 0                                   | 0             | 0                                  | 1,106          |
| <b>Net other-than-temporary impairment losses</b>                       | <b>0</b>                            | <b>0</b>      | <b>0</b>                           | <b>(2,404)</b> |
| Service fees on loan and deposit accounts                               | 534                                 | 546           | 1,690                              | 1,834          |
| Income on bank-owned life insurance                                     | 245                                 | 256           | 725                                | 765            |
| Gain on sale of investment securities                                   | 74                                  | 0             | 140                                | 350            |
| Gain on sale of loans   | 138                                 | 165           | 374                                | 420            |
| Other   | 177                                 | 76            | 588                                | 224            |
| <b>Total non-interest income</b>  | <b>1,168</b>                        | <b>1,043</b>  | <b>3,517</b>                       | <b>1,189</b>   |
| <b>Non-interest expense:</b>  |                                     |               |                                    |                |
| Salaries and employee benefits  | 6,017                               | 4,526         | 16,630                             | 13,533         |
| Occupancy   | 1,267                               | 1,146         | 3,714                              | 3,428          |
| Equipment   | 792                                 | 734           | 2,366                              | 2,184          |
| Federal deposit insurance premiums                                      | 191                                 | 308           | 678                                | 898            |
| Other general and administrative expenses                               | 954                                 | 952           | 2,887                              | 2,843          |
| <b>Total non-interest expense</b>                                       | <b>9,221</b>                        | <b>7,666</b>  | <b>26,275</b>                      | <b>22,886</b>  |

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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Income before income taxes                                   | 4,904      | 4,973      | 15,471     | 12,360     |
| Income taxes   | 1,918      | 1,839      | 6,100      | 4,530      |
| Net income   | \$ 2,986   | \$ 3,134   | \$ 9,371   | \$ 7,830   |
| Basic earnings per share                                     | \$ 0.28    | \$ 0.28    | \$ 0.85    | \$ 0.69    |
| Diluted earnings per share                                   | \$ 0.28    | \$ 0.28    | \$ 0.84    | \$ 0.69    |
| Cash dividends declared per common share                     | \$ 0.09    | \$ 0.07    | \$ 0.25    | \$ 0.17    |
| Basic weighted average shares outstanding                    | 10,659,532 | 11,334,058 | 10,969,320 | 11,321,912 |
| Diluted weighted average shares outstanding                  | 10,835,649 | 11,344,622 | 11,117,444 | 11,356,737 |
| See accompanying notes to consolidated financial statements. |            |            |            |            |

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

(Dollars in thousands)

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>(Loss)/Income | Total<br>Stockholders<br>Equity |
|---|-----------------|----------------------------------|----------------------------|----------------------|--|---------------------------------|
| Balances at December 31, 2009   | \$ 122          | 118,823                          | (9,297)                    | 111,082              | (1,059)  | 219,671                         |
| Comprehensive income:   |                 |                                  |                            |                      |  |                                 |
| Net income  | 0               | 0                                | 0                          | 7,830                | 0  | 7,830                           |
| Other comprehensive loss, net of tax:   |                 |                                  |                            |                      |  |                                 |
| Investment securities:  |                 |                                  |                            |                      |  |                                 |
| Noncredit related losses on securities not expected to be sold, net of taxes of \$427 | 0               | 0                                | 0                          | 0                    | (679)  | (679)                           |
| Total comprehensive income  | 0               | 0                                | 0                          | 0                    | 0  | 7,151                           |
| Cash dividends declared   | 0               | 0                                | 0                          | (1,922)              | 0  | (1,922)                         |
| Stock compensation expense  | 0               | 233                              | 0                          | 0                    | 0  | 233                             |
| Allocation of 36,699 ESOP shares  | 0               | 318                              | 367                        | 0                    | 0  | 685                             |
| Balances at September 30, 2010  | \$ 122          | 119,374                          | (8,930)                    | 116,990              | (1,738)  | 225,818                         |
| Balances at December 31, 2010   | \$ 122          | 119,153                          | (8,808)                    | 119,397              | (2,505)  | 227,359                         |
| Comprehensive income:   |                 |                                  |                            |                      |  |                                 |
| Net income  | 0               | 0                                | 0                          | 9,371                | 0  | 9,371                           |
| Other comprehensive loss, net of tax:   |                 |                                  |                            |                      |  |                                 |
| Investment securities:  |                 |                                  |                            |                      |  |                                 |
| Change in unrealized loss on securities, net of taxes of \$119                        | 0               | 0                                | 0                          | 0                    | 189  | 189                             |
| Total comprehensive income  |                 |                                  |                            |                      |  | 9,560                           |
| Cash dividends declared   | 0               | 0                                | 0                          | (2,746)              | 0  | (2,746)                         |
| Stock compensation expense  | 1               | 2,790                            | 0                          | 0                    | 0  | 2,791                           |
| Allocation of 36,699 ESOP shares  | 0               | 362                              | 367                        | 0                    | 0  | 729                             |
| Repurchase of 1,202,471 shares of company stock                                       | (12)            | (23,463)                         | 0                          | 0                    | 0  | (23,475)                        |
| Balances at September 30, 2011  | \$ 111          | 98,842                           | (8,441)                    | 126,022              | (2,316)  | 214,218                         |

See accompanying notes to consolidated financial statements.



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

(Dollars in thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|--|-----------------|
|   | <b>2011</b>                                | <b>2010</b>     |
| <b>Cash flows from operating activities:</b>                                      |  |                 |
| Net income  | \$ 9,371                                   | \$ 7,830        |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |                 |
| Provision for loan losses   | 83   | 276             |
| Depreciation and amortization   | 835  | 681             |
| Deferred income tax benefit   | (1,126)                                    | (1,315)         |
| Amortization of fees, discounts, and premiums                                     | (44)                                       | 50              |
| Origination of loans held for sale  | (34,600)                                   | (31,686)        |
| Proceeds from sales of loans held for sale  | 35,221                                     | 31,161          |
| Gain on sale of loans, net  | (374)                                      | (420)           |
| Net gain on sale of real estate owned   | 0  | (1)             |
| Other-than-temporary impairment loss on investment                                | 0  | 2,404           |
| Purchases of investment securities held for trading                               | (36,171)                                   | (18,143)        |
| Proceeds from sale of investment securities held for trading                      | 36,311                                     | 18,244          |
| Gain on sale of investment securities held for trading                            | (140)                                      | (101)           |
| Gain on sale of investment securities available for sale                          | 0  | (249)           |
| Net (gain) loss on sale of premises and equipment                                 | (5)  | 59              |
| ESOP expense  | 729  | 685             |
| Share-based compensation expense  | 2,791                                      | 233             |
| (Increase) decrease in accrued interest receivable                                | (346)                                      | 43              |
| Net increase in bank-owned life insurance   | (725)                                      | (765)           |
| Net decrease in prepaid expenses and other assets                                 | 1,543                                      | 457             |
| Net decrease in accounts payable and accrued expenses                             | (703)                                      | (1,007)         |
| Net decrease in income taxes payable  | (161)                                      | (174)           |
| <b>Net cash provided by operating activities</b>                                  | <b>12,489</b>                              | <b>8,262</b>    |
| <b>Cash flows from investing activities:</b>                                      |  |                 |
| Purchases of investment securities held to maturity                               | (211,257)                                  | (81,730)        |
| Purchases of investment securities available for sale                             | 0  | (49,206)        |
| Principal repayments on investment securities held to maturity                    | 97,289                                     | 104,872         |
| Principal repayments on investment securities available for sale                  | 525  | 90              |
| Proceeds from sale of investment securities available for sale                    | 0  | 49,365          |
| Loan originations, net of principal repayments on loans receivable                | (20,403)                                   | (38,556)        |
| Proceeds from sale of real estate owned   | 0  | 160             |
| Proceeds from disposals of premises and equipment                                 | 5  | 0               |
| Purchases of premises and equipment   | (973)                                      | (996)           |
| <b>Net cash used in investing activities</b>                                      | <b>(134,814)</b>                           | <b>(16,001)</b> |

(Continued)



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

(Dollars in thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |               |
|---|--|---------------|
|   | <b>2011</b>                                | <b>2010</b>   |
| <b>Cash flows from financing activities:</b>                          |  |               |
| Net increase in deposits  | \$ 62,847                                  | \$ 64,226     |
| Proceeds from advances from the Federal Home Loan Bank                | 10,000                                     | 10,000        |
| Proceeds from securities sold under agreements to repurchase          | 47,000                                     | 1,136         |
| Repayments of securities sold under agreements to repurchase          | (32,000)                                   | (26,136)      |
| Purchases of Fed Funds  | 10   | 10            |
| Sales of Fed Funds  | (10)                                       | (10)          |
| Net decrease in advance payments by borrowers for taxes and insurance | (1,288)                                    | (716)         |
| Repurchases of company stock  | (23,475)                                   | 0             |
| Cash dividends paid   | (2,746)                                    | (1,922)       |
| <b>Net cash provided by financing activities</b>                      | <b>60,338</b>                              | <b>46,588</b> |
| <br>  |  |               |
| Net increase (decrease) in cash and cash equivalents                  | (61,987)                                   | 38,849        |
| Cash and cash equivalents at beginning of the period                  | 194,435                                    | 135,953       |
| <br>  |  |               |
| Cash and cash equivalents at end of the period                        | \$ 132,448                                 | \$ 174,802    |
| <br>  |  |               |
| <b>Supplemental disclosure of cash flow information:</b>              |  |               |
| Cash paid for:  |  |               |
| Interest on deposits and borrowings                                   | \$ 8,531                                   | \$ 11,917     |
| Income taxes  | 7,388                                      | 6,019         |
| <br>  |  |               |
| <b>Supplemental disclosure of noncash investing activities:</b>       |  |               |
| Loans transferred to real estate owned                                | \$ 162                                     | \$ 0          |
| See accompanying notes to consolidated financial statements.          |  |               |

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**TERRITORIAL BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**(1) Basis of Presentation**

The accompanying unaudited consolidated financial statements of Territorial Bancorp Inc. 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 Territorial Bancorp Inc. s consolidated financial statements and notes thereto filed as part of the Annual Report on Form 10-K for the year ended December 31, 2010. 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) Organization**

On November 4, 2008, the Board of Directors of Territorial Mutual Holding Company approved a plan of conversion and reorganization under which Territorial Mutual Holding Company would convert from a mutual holding company to a stock holding company. The conversion to a stock holding company was approved by the depositors and borrowers of Territorial Savings Bank and the Office of Thrift Supervision (OTS) and included the filing of a registration statement with the U.S. Securities and Exchange Commission. Upon the completion of the conversion and reorganization on July 10, 2009, Territorial Mutual Holding Company and Territorial Savings Group, Inc. ceased to exist as separate legal entities and Territorial Bancorp Inc. became the holding company for Territorial Savings Bank. A total of 12,233,125 shares were issued in the conversion at \$10 per share, raising \$122.3 million of gross proceeds. \$3.7 million of conversion expenses were 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.

Upon completion of the conversion and reorganization, a special liquidation account was established in an amount equal to the total equity of Territorial Mutual Holding Company as of December 31, 2008. The liquidation account is to provide eligible account holders and supplemental eligible account holders who maintain their deposit accounts with Territorial Savings Bank after the conversion with a liquidation interest in the unlikely event of the complete liquidation of Territorial Savings Bank after the conversion. The liquidation account will be reduced annually to the extent that eligible account holders and supplemental eligible account holders have reduced their qualifying deposits. Subsequent increases will not restore an eligible account holder s or supplemental eligible account holder s interest in the liquidation account. In the event of a complete liquidation of Territorial Savings Bank, and only in such event, each account holder will be entitled to receive a distribution from the liquidation account in an amount proportionate to the adjusted qualifying account balances then held.

**(3) Recently Adopted Accounting Pronouncements**

In January 2010, the Financial Accounting Standards Board ( FASB ) amended the Fair Value Measurements and Disclosures topic of the FASB Accounting Standards Codification ( ASC ). The amendment requires disclosures about the significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers, and requires the reconciliation of activity in Level 3 fair value measurements be made on a gross basis. The amendment also clarifies the level of

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disaggregation required in disclosures and the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for Level 2 or Level 3 items. The part of the amendment related to the reconciliation of Level 3 activity is effective for interim and annual periods beginning after December 15, 2010, and was adopted by the Company on January 1, 2011. The remaining parts of the amendment were effective for interim and annual periods beginning after December 15, 2009, and were adopted by the Company on January 1, 2010. The Fair Value of Financial Instruments footnote has been updated to include the revised disclosures.

In April 2011, the FASB amended the Receivables topic of the FASB ASC. The amendment helps creditors determine whether a troubled debt restructuring has occurred by clarifying whether a restructuring constitutes a concession and whether the debtor is experiencing financial difficulties. The amendment also requires disclosures related to troubled debt restructurings that were initially effective for periods ending after December 15, 2010, but deferred to make the effective date concurrent with this amendment. The amendment is effective for the first interim or annual period beginning on or after June 15, 2011, and was adopted by the Company on July 1, 2011. The adoption did not have a material effect on its consolidated financial statements.

In April 2011, the FASB amended the Transfers and Servicing topic of the FASB ASC. The amendment modifies the criteria used to determine whether a repurchase agreement is accounted for as a sale or as a secured borrowing. The amendment is effective for interim or annual periods beginning on or after December 15, 2011. Early adoption is not permitted. The Company does not expect the adoption of this amendment to have any effect on its consolidated financial statements.

In May 2011, the FASB amended the Fair Value Measurement topic of the FASB ASC. The amendment results in common fair value measurement and disclosure requirements in U.S. generally accepted accounting principles and International Financial Reporting Standards. The amendment both clarifies the intent about existing fair value measurements as well as changes the principle or requirement for measuring fair value or disclosing fair value information. The amendment is effective for interim or annual periods beginning after December 15, 2011. Early application is not permitted. The Company does not expect the adoption of this amendment to have a material effect on its consolidated financial statements.

In June 2011, the FASB amended the Comprehensive Income topic of the FASB ASC. The amendment eliminates the option of presenting components of other comprehensive income as part of the statement of changes in stockholders' equity. Non-owner changes in stockholders' equity must be presented either in a continuous statement of comprehensive income or in two separate but consecutive statements. The amendment is effective for interim or annual periods beginning after December 15, 2011, with early adoption permitted. The adoption of this amendment will affect the location of disclosures related to other comprehensive income, but the Company does not expect any other material effect on its consolidated financial statements.

**(4) Cash and Cash Equivalents**

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

| (Dollars in thousands)                   | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| Cash and due from banks                  | \$ 9,266              | \$ 8,827             |
| Interest-earning deposits in other banks | 123,182               | 185,608              |
| <b>Cash and cash equivalents</b>         | <b>\$ 132,448</b>     | <b>\$ 194,435</b>    |

**Table of Contents****(5) Investment Securities**

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

| (Dollars in thousands)                               | Amortized<br>cost | Gross unrealized<br>Gains | Losses         | Estimated<br>fair value |
|--|-------------------|---------------------------|----------------|-------------------------|
| <b>September 30, 2011:</b>                           |                   |                           |                |                         |
| Held to maturity:                                    |                   |                           |                |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 658,542        | 36,324                    | (38)           | \$ 694,828              |
| Trust preferred securities                           | 32                | 136                       | 0              | 168                     |
| <b>Total</b>   | <b>\$ 658,574</b> | <b>36,460</b>             | <b>(38)</b>    | <b>\$ 694,996</b>       |
| <b>December 31, 2010:</b>                            |                   |                           |                |                         |
| Held to maturity:                                    |                   |                           |                |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 530,523        | 18,191                    | (1,998)        | \$ 546,716              |
| Trust preferred securities                           | 32                | 96                        | 0              | 128                     |
| <b>Total</b>   | <b>\$ 530,555</b> | <b>18,287</b>             | <b>(1,998)</b> | <b>\$ 546,844</b>       |
| Available for sale:                                  |                   |                           |                |                         |
| U.S. government-sponsored mortgage-backed securities | \$ 15,540         | 0                         | (530)          | \$ 15,010               |
| <b>Total</b>   | <b>\$ 15,540</b>  | <b>0</b>                  | <b>(530)</b>   | <b>\$ 15,010</b>        |

\$15.0 million of U.S. government-sponsored mortgage-backed securities were reclassified from available-for-sale to held-to-maturity during the three months ended June 30, 2011. Management considers the held-to-maturity classification of these securities to be appropriate as the Company has the positive intent and ability to hold these securities to maturity.

The amortized cost and estimated fair value of investment securities at September 30, 2011 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 5 years through 10 years | \$ 8,018          | \$ 8,278                |
| Due after 10 years                 | 650,556           | 686,718                 |
| <b>Total</b>                       | <b>\$ 658,574</b> | <b>\$ 694,996</b>       |

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

| (Dollars in thousands) | Three months ended<br>September 30, |      | Nine months ended<br>September 30, |           |
|------------------------|-------------------------------------|------|------------------------------------|-----------|
|                        | 2011                                | 2010 | 2011                               | 2010      |
| Proceeds from sales    | \$ 16,445                           | \$ 0 | \$ 36,311                          | \$ 67,609 |
| Gross gains            | 74                                  | 0    | 140                                | 350       |
| Gross losses           | 0                                   | 0    | 0                                  | 0         |

Investment securities with carrying values of \$296.2 million at September 30, 2011 were pledged to secure public deposits, securities sold under agreements to repurchase and transaction clearing accounts.

Provided below is a summary of investment securities which were in an unrealized loss position at September 30, 2011 and December 31, 2010. 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<br>securities | Total      |                      |
|---|---------------------|----------------------|---------------------|----------------------|-------------------------|------------|----------------------|
|   | Fair value          | Unrealized<br>losses | Fair value          | Unrealized<br>losses |                         | Fair value | Unrealized<br>losses |
| <b>September 30, 2011:</b>                          |                     |                      |                     |                      |                         |            |                      |
| Mortgage-backed securities                          | \$ 2,599            | 23                   | 676                 | 15                   | 9                       | 3,275      | 38                   |
| Total   | \$ 2,599            | 23                   | 676                 | 15                   | 9                       | 3,275      | 38                   |
| <b>December 31, 2010:</b>                           |                     |                      |                     |                      |                         |            |                      |
| Mortgage-backed securities                          | \$ 98,524           | 2,480                | 2,962               | 48                   | 17                      | 101,486    | 2,528                |
| Total   | \$ 98,524           | 2,480                | 2,962               | 48                   | 17                      | 101,486    | 2,528                |

**Trust Preferred Securities.** At September 30, 2011, the Company owns two trust preferred securities, PreTSL XXIII and XXIV, with a carrying value of \$32,000. The difference between the carrying value of \$32,000 and the remaining amortized cost basis of \$1.1 million is included as a component of accumulated other comprehensive loss, net of taxes, and is related to non-credit factors such as the trust preferred securities market being inactive. 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.

The trust preferred securities market is considered to be inactive as there were only five transactions in the last 21 months in similar tranches to the securities owned by the Company. The

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Company used a discounted cash flow model to determine whether these securities are other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows.

Based on the Company's review, the Company's investment in trust preferred securities did not incur additional impairment during the quarter ending September 30, 2011 as the present value of cash flows exceed the amortized cost basis of \$1.1 million.

At September 30, 2011, PreTSL XXIII and XXIV are rated C by Fitch.

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

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

| (Dollars in thousands)   | 2011     | 2010     |
|--|----------|----------|
| Balance at January 1   | \$ 5,885 | \$ 3,481 |
| Credit losses on debt securities for which other-than-temporary impairment was not previously recognized | 0        | 2,404    |
| Balance at September 30  | \$ 5,885 | \$ 5,885 |

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

| (Dollars in thousands)  | September 30, 2011 | December 31, 2010 |
|---|--------------------|-------------------|
| Non-credit losses on other-than-temporarily impaired securities | \$ 679             | \$ 679            |

**(6) Loans Receivable**

The components of loans receivable are as follows:

| (Dollars in thousands)                | September 30, 2011 | December 31, 2010 |
|---------------------------------------|--------------------|-------------------|
| Real estate loans:                    |                    |                   |
| First mortgages:                      |                    |                   |
| One- to four-family residential       | \$ 626,719         | \$ 604,456        |
| Multi-family residential              | 6,214              | 5,408             |
| Construction, commercial, and other   | 14,993             | 14,412            |
| Home equity loans and lines of credit | 17,826             | 20,064            |
| Total real estate loans               | 665,752            | 644,340           |
| Other loans:                          |                    |                   |
| Loans on deposit accounts             | 737                | 895               |



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|                                 |                   |                   |
|---------------------------------|-------------------|-------------------|
| Consumer and other loans        | 4,787             | 4,740             |
| <b>Total other loans</b>        | <b>5,524</b>      | <b>5,635</b>      |
| Less:                           |                   |                   |
| Net unearned fees and discounts | (5,767)           | (5,585)           |
| Undisbursed loan funds          | (1,223)           | (1,112)           |
| Allowance for loan losses       | (1,552)           | (1,488)           |
|                                 | (8,542)           | (8,185)           |
| <b>Loans receivable, net</b>    | <b>\$ 662,734</b> | <b>\$ 641,790</b> |

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

| (Dollars in thousands)                            | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2011                                | 2010     | 2011                               | 2010     |
| Balance, beginning of period                      | \$ 1,592                            | \$ 1,737 | \$ 1,488                           | \$ 1,681 |
| Provision (reversal of allowance) for loan losses | (39)                                | 118      | 83                                 | 276      |
|   | 1,553                               | 1,855    | 1,571                              | 1,957    |
| Charge-offs                                       | (7)                                 | (378)    | (62)                               | (501)    |
| Recoveries  | 6                                   | 94       | 43                                 | 115      |
| Net charge-offs                                   | (1)                                 | (284)    | (19)                               | (386)    |
| Balance, end of period                            | \$ 1,552                            | \$ 1,571 | \$ 1,552                           | \$ 1,571 |

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

| (Dollars in thousands)                            | Residential<br>Mortgage | Construction<br>Commercial<br>and Other<br>Mortgage<br>Loans | Home<br>Equity and<br>Lines of<br>Credit | Consumer<br>and<br>Other | Unallocated | Totals   |
|---|-------------------------|--|--|--------------------------|-------------|----------|
| <b>Three months ended September 30, 2011:</b>     |                         |  |  |                          |             |          |
| Balance, beginning of period                      | \$ 615                  | \$ 390   | \$ 277                                   | \$ 193                   | \$ 117      | \$ 1,592 |
| Provision (reversal of allowance) for loan losses | (13)                    | (32)   | (9)                                      | 15                       | 0           | (39)     |
|   | 602                     | 358  | 268                                      | 208                      | 117         | 1,553    |
| Charge-offs                                       | 0                       | 0  | 0  | (7)                      | 0           | (7)      |
| Recoveries  | 2                       | 0  | 0  | 4                        | 0           | 6        |
| Net charge-offs                                   | 2                       | 0  | 0  | (3)                      | 0           | (1)      |
| Balance, end of period                            | \$ 604                  | \$ 358   | \$ 268                                   | \$ 205                   | \$ 117      | \$ 1,552 |
| <b>Nine months ended September 30, 2011:</b>      |                         |  |  |                          |             |          |
| Balance, beginning of period                      | \$ 583                  | \$ 277   | \$ 305                                   | \$ 208                   | \$ 115      | \$ 1,488 |
| Provision (reversal of allowance) for loan losses | 23                      | 81   | (37)                                     | 14                       | 2           | 83       |
|   | 606                     | 358  | 268                                      | 222                      | 117         | 1,571    |
| Charge-offs                                       | (27)                    | 0  | 0  | (35)                     | 0           | (62)     |
| Recoveries  | 25                      | 0  | 0  | 18                       | 0           | 43       |
| Net charge-offs                                   | (2)                     | 0  | 0  | (17)                     | 0           | (19)     |

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|                        |        |        |        |        |        |          |
|------------------------|--------|--------|--------|--------|--------|----------|
| Balance, end of period | \$ 604 | \$ 358 | \$ 268 | \$ 205 | \$ 117 | \$ 1,552 |
|------------------------|--------|--------|--------|--------|--------|----------|

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

| (Dollars in thousands)                | Residential<br>Mortgage | Construction<br>Commercial<br>and Other<br>Mortgage<br>Loans | Home<br>Equity and<br>Lines of<br>Credit | Consumer<br>and<br>Other | Unallocated | Totals     |
|---------------------------------------|-------------------------|--|--|--------------------------|-------------|------------|
| <b>September 30, 2011:</b>            |                         |  |  |                          |             |            |
| Allowance for loan losses:            |                         |  |  |                          |             |            |
| Ending allowance balance:             |                         |  |  |                          |             |            |
| Individually evaluated for impairment | \$ 0                    | \$ 0   | \$ 0                                     | \$ 0                     | \$ 0        | \$ 0       |
| Collectively evaluated for impairment | 604                     | 358  | 268                                      | 205                      | 117         | 1,552      |
| Total ending allowance balance        | \$ 604                  | \$ 358   | \$ 268                                   | \$ 205                   | \$ 117      | \$ 1,552   |
| Loans:                                |                         |  |  |                          |             |            |
| Ending loan balance:                  |                         |  |  |                          |             |            |
| Individually evaluated for impairment | \$ 4,980                | \$ 0   | \$ 0                                     | \$ 53                    | \$ 0        | \$ 5,033   |
| Collectively evaluated for impairment | 622,288                 | 13,656   | 17,838                                   | 5,471                    | 0           | 659,253    |
| Total ending loan balance             | \$ 627,268              | \$ 13,656  | \$ 17,838                                | \$ 5,524                 | \$ 0        | \$ 664,286 |
| <b>December 31, 2010:</b>             |                         |  |  |                          |             |            |
| Allowance for loan losses:            |                         |  |  |                          |             |            |
| Ending allowance balance:             |                         |  |  |                          |             |            |
| Individually evaluated for impairment | \$ 0                    | \$ 0   | \$ 0                                     | \$ 0                     | \$ 0        | \$ 0       |
| Collectively evaluated for impairment | 583                     | 277  | 305                                      | 208                      | 115         | 1,488      |
| Total ending allowance balance        | \$ 583                  | \$ 277   | \$ 305                                   | \$ 208                   | \$ 115      | \$ 1,488   |
| Loans:                                |                         |  |  |                          |             |            |
| Ending loan balance:                  |                         |  |  |                          |             |            |
| Individually evaluated for impairment | \$ 3,401                | \$ 2   | \$ 0                                     | \$ 5                     | \$ 0        | \$ 3,408   |
| Collectively evaluated for impairment | 600,981                 | 13,185   | 20,079                                   | 5,625                    | 0           | 639,870    |
| Total ending loan balance             | \$ 604,382              | \$ 13,187  | \$ 20,079                                | \$ 5,630                 | \$ 0        | \$ 643,278 |

The table below presents the balance of impaired loans and the related amount of allocated loan loss allowances:

| (Dollars in thousands)                            | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Loans with no allocated allowance for loan losses | \$ 5,033              | \$ 3,408             |
| Loans with allocated allowance for loan losses    | 0                     | 0                    |
| Total impaired loans                              | \$ 5,033              | \$ 3,408             |
| Amount of allocated loan loss allowance           | \$ 0                  | \$ 0                 |



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

| (Dollars in thousands)                       | Recorded<br>Investment | Unpaid<br>Principal<br>Balance |
|--|------------------------|--------------------------------|
| <b>September 30, 2011:</b>                   |                        |                                |
| With no related allowance recorded:          |                        |                                |
| One- to four-family residential mortgages    | \$ 4,980               | \$ 5,113                       |
| Consumer and other                           | 53                     | 53                             |
| <b>Total</b>                                 | <b>\$ 5,033</b>        | <b>\$ 5,166</b>                |
| <br>   |                        |                                |
| <b>December 31, 2010:</b>                    |                        |                                |
| With no related allowance recorded:          |                        |                                |
| One- to four-family residential mortgages    | \$ 3,401               | \$ 3,413                       |
| Construction, commercial and other mortgages | 2                      | 2                              |
| Consumer and other                           | 5                      | 5                              |
| <b>Total</b>                                 | <b>\$ 3,408</b>        | <b>\$ 3,420</b>                |

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

| (Dollars in thousands)                       | For the three months ended<br>September 30 |                                  | For the nine months<br>ended<br>September 30 |                                  |
|--|--|----------------------------------|--|----------------------------------|
|  | Average<br>Recorded<br>Investment          | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment            | Interest<br>Income<br>Recognized |
| <b>2011:</b>                                 |  |                                  |  |                                  |
| With no related allowance recorded:          |  |                                  |  |                                  |
| One- to four-family residential mortgages    | \$ 4,292                                   | \$ 40                            | \$ 4,982                                     | \$ 108                           |
| Consumer and other                           | 29   | 0                                | 54   | 0                                |
| <b>Total</b>                                 | <b>\$ 4,321</b>                            | <b>\$ 40</b>                     | <b>\$ 5,036</b>                              | <b>\$ 108</b>                    |
| <br>   |  |                                  |  |                                  |
| <b>2010:</b>                                 |  |                                  |  |                                  |
| With no related allowance recorded:          |  |                                  |  |                                  |
| One- to four-family residential mortgages    | \$ 2,911                                   | \$ 35                            | \$ 3,018                                     | \$ 98                            |
| Construction, commercial and other mortgages | 97   | 0                                | 26   | 0                                |
| Consumer and other                           | 5  | 0                                | 150  | 0                                |
| <b>Total</b>                                 | <b>\$ 3,013</b>                            | <b>\$ 35</b>                     | <b>\$ 3,194</b>                              | <b>\$ 98</b>                     |

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There were no loans individually evaluated for impairment with a related allowance for loan loss as of September 30, 2011 or December 31, 2010.

Impaired loans at September 30, 2011 and December 31, 2010 amounted to \$5.0 million and \$3.4 million, respectively, and included all nonaccrual and restructured loans. During the nine months ended September 30, 2011, the average recorded investment in impaired loans was \$5.0 million and interest income recognized on impaired loans was \$108,000. During the nine months ended September 30, 2010, the average recorded investment in impaired loans was \$3.2 million and interest income recognized on impaired loans was \$98,000.

The table below presents the aging of loans and accrual status by class of loans as of September 30, 2011 and December 31, 2010:

|  | 30 Days Past Due | 59 Days Past Due | 60 Days Past Due | 89 Days Past Due | 90 Days or Greater Past Due | Total Past Due    | Loans Not Past Due | Total Loans | Nonaccrual Loans | Loans More Than 90 Days Past Due and Still Accruing |
|--|------------------|------------------|------------------|------------------|-----------------------------|-------------------|--------------------|-------------|------------------|---|
| (Dollars in thousands)                       |                  |                  |                  |                  |                             |                   |                    |             |                  |   |
| <b>September 30, 2011:</b>                   |                  |                  |                  |                  |                             |                   |                    |             |                  |   |
| One- to four family residential mortgages    | \$ 629           | \$ 403           | \$ 2,384         | \$ 3,416         | \$ 617,680                  | \$ 621,096        | \$ 2,384           | \$ 0        | \$ 0             | \$ 0  |
| Multi-family residential mortgages           | 0                | 0                | 0                | 0                | 6,172                       | 6,172             | 0                  | 0           | 0                | 0   |
| Construction, commercial and other mortgages | 238              | 0                | 0                | 238              | 13,418                      | 13,656            | 0                  | 0           | 0                | 0   |
| Home equity and lines of credit              | 0                | 0                | 0                | 0                | 17,838                      | 17,838            | 0                  | 0           | 0                | 0   |
| Loans on deposit accounts                    | 0                | 0                | 0                | 0                | 737                         | 737               | 0                  | 0           | 0                | 0   |
| Consumer and other                           | 19               | 7                | 53               | 79               | 4,708                       | 4,787             | 53                 | 0           | 0                | 0   |
| <b>Total</b>                                 | <b>\$ 886</b>    | <b>\$ 410</b>    | <b>\$ 2,437</b>  | <b>\$ 3,733</b>  | <b>\$ 660,553</b>           | <b>\$ 664,286</b> | <b>\$ 2,437</b>    | <b>\$ 0</b> | <b>\$ 0</b>      | <b>\$ 0</b>   |
| <b>December 31, 2010:</b>                    |                  |                  |                  |                  |                             |                   |                    |             |                  |   |
| One- to four-family residential mortgages    | \$ 1,476         | \$ 0             | \$ 801           | \$ 2,277         | \$ 596,732                  | \$ 599,009        | \$ 801             | \$ 0        | \$ 0             | \$ 0  |
| Multi-family residential mortgages           | 0                | 0                | 0                | 0                | 5,373                       | 5,373             | 0                  | 0           | 0                | 0   |
| Construction, commercial and other mortgages | 0                | 0                | 2                | 2                | 13,185                      | 13,187            | 2                  | 0           | 0                | 0   |
| Home equity and lines of credit              | 58               | 0                | 0                | 58               | 20,021                      | 20,079            | 0                  | 0           | 0                | 0   |
| Loans on deposit accounts                    | 0                | 0                | 0                | 0                | 895                         | 895               | 0                  | 0           | 0                | 0   |
| Consumer and other                           | 10               | 8                | 5                | 23               | 4,712                       | 4,735             | 5                  | 0           | 0                | 0   |
| <b>Total</b>                                 | <b>\$ 1,544</b>  | <b>\$ 8</b>      | <b>\$ 808</b>    | <b>\$ 2,360</b>  | <b>\$ 640,918</b>           | <b>\$ 643,278</b> | <b>\$ 808</b>      | <b>\$ 0</b> | <b>\$ 0</b>      | <b>\$ 0</b>   |

The Company primarily uses the aging of loans and accrual status to monitor the credit quality of its loan portfolio. When a mortgage loan becomes seriously delinquent (90 days or more contractually past due), it displays weaknesses which may result in a loss. As a loan becomes more delinquent, the likelihood of the borrower repaying the loan decreases and the loan becomes more collateral dependent. A mortgage loan becomes collateral dependent when the proceeds for repayment can be expected to

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come only from the sale or operation of the collateral and not from borrower repayments. Generally, new appraisals are obtained after a loan becomes collateral dependent or is five months delinquent. The carrying value of collateral dependent loans is adjusted to the fair market value of the collateral less selling costs. Any commercial real estate, commercial, or construction loan that has a loan balance in excess of a specified amount is also periodically reviewed to determine whether the loan exhibits any weaknesses and is performing in accordance with its contractual terms.

The Company had 11 nonaccrual loans with a book value of \$2.4 million at September 30, 2011 and seven nonaccrual loans with a book value of \$808,000 as of December 31, 2010. The Company collected or recognized interest income on nonaccrual loans of \$8,000 and \$0 during the nine months ended September 30, 2011 and 2010, respectively. The Company would have recognized additional interest income of \$84,000 and \$19,000 during the nine months ended September 30, 2011 and 2010, respectively, had the loans been accruing interest. The Company did not have any loans 90 or more days past due and still accruing interest as of September 30, 2011 and December 31, 2010.

The table below presents information about the Company's new troubled debt restructurings by class of loans:

| (Dollars in thousands)                 | 2011            |                                      |                                       | 2010            |                                      |                                       |
|--|-----------------|--------------------------------------|---------------------------------------|-----------------|--------------------------------------|---------------------------------------|
|  | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | Number of Loans | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| <b>Nine months ended September 30:</b> |                 |                                      |                                       |                 |                                      |                                       |
| One- to four-family residential        | 0               | \$ 0                                 | \$ 0                                  | 2               | \$ 417                               | \$ 396                                |
| <b>Total</b>                           | <b>0</b>        | <b>\$ 0</b>                          | <b>\$ 0</b>                           | <b>2</b>        | <b>\$ 417</b>                        | <b>\$ 396</b>                         |

There were no new troubled debt restructurings during the three months ended September 30, 2011 or 2010. There were also no new troubled debt restructurings within the past twelve months that subsequently defaulted.

The Company had nine troubled debt restructurings totaling \$2.6 million as of September 30, 2011, all of which were one- to four-family residential mortgage loans and considered to be impaired. Eight of the nine loans are performing in accordance with their restructured terms and accruing interest at September 30, 2011. One loan was 29 days delinquent and still accruing interest at September 30, 2011. There were nine restructured one- to four-family residential mortgage loans totaling \$2.6 million as of December 31, 2010 that were considered to be impaired. Eight of the nine loans were performing in accordance with their restructured terms and accruing interest as of December 31, 2010. One loan was 29 days delinquent and still accruing interest at December 31, 2010. Restructurings include deferrals of interest and/or principal payments and temporary or permanent reductions in interest rates due to the financial difficulties of the borrowers. We have no commitments to lend any additional funds to these borrowers. The troubled debt restructurings were individually evaluated for impairment and did not have a significant effect on the allowance for loan losses.

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

During the nine months ended September 30, 2011 and 2010, the Company sold \$35.3 million and \$31.1 million, respectively, of residential mortgage loans held for sale and recognized gains of \$374,000 and \$420,000, respectively. During the three months ended September 30, 2011 and 2010, the Company sold \$9.2 million and \$12.4 million, respectively, of mortgage loans held for sale and recognized gains of



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\$138,000 and \$165,000, respectively. The Company had 13 residential mortgage loans held for sale totaling \$3.0 million at September 30, 2011 and 13 residential mortgage loans held for sale totaling \$3.2 million at December 31, 2010. We have not had to repurchase any loans from Freddie Mac for the nine months ended September 30, 2011 and 2010.

The Company serviced loans for others of \$120.8 million at September 30, 2011 and \$131.6 million at December 31, 2010. Of these amounts, \$7.1 million and \$8.1 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at September 30, 2011 and December 31, 2010, respectively. The amount of contractually specified servicing fees earned for the nine-month periods ended September 30, 2011 and 2010 was \$266,000 and \$302,000, respectively. The amount of contractually specified servicing fees earned for the three-month periods ended September 30, 2011 and 2010 was \$87,000 and \$100,000, respectively. The fees are reported in service fees on loan and deposit accounts in the consolidated statements of income.

**(7) 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 are summarized as follows:

| (Dollars in thousands)  | September 30, 2011   |                       | December 31, 2010    |                       |
|-------------------------|----------------------|-----------------------|----------------------|-----------------------|
|                         | Repurchase Liability | Weighted Average Rate | Repurchase Liability | Weighted Average Rate |
| <b>Maturing:</b>        |                      |                       |                      |                       |
| 1 year or less          | \$ 40,200            | 4.72%                 | \$ 43,900            | 3.53%                 |
| Over 1 year to 2 years  | 33,000               | 3.91                  | 28,300               | 4.75                  |
| Over 2 years to 3 years | 0                    | 0                     | 33,000               | 3.91                  |
| Over 3 years to 4 years | 47,000               | 2.11                  | 0                    | 0                     |
|                         | \$ 120,200           | 3.48%                 | \$ 105,200           | 3.98%                 |

Below is a summary comparing the carrying value and fair value of securities pledged to secure repurchase agreements, the repurchase liability, and the amount at risk at September 30, 2011. 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 N.A. and JP Morgan Securities LLC. The securities pledged are issued and guaranteed by U.S. government-sponsored enterprises.

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| (Dollars in thousands) | Carrying<br>value of<br>securities | Fair<br>value of<br>securities | Repurchase<br>liability | Amount<br>at risk | Weighted<br>average<br>months to<br>maturity |
|------------------------|------------------------------------|--------------------------------|-------------------------|-------------------|--|
| <b>Maturing:</b>       |                                    |                                |                         |                   |  |
| Over 90 days           | \$ 137,143                         | \$ 145,209                     | \$ 120,200              | \$ 25,009         | 24   |
|                        | \$ 137,143                         | \$ 145,209                     | \$ 120,200              | \$ 25,009         | 24   |

**(8) 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 and benefits will not increase with any additional years of service. Net periodic benefit cost, subsequent to December 31, 2008, has not been significant and is not disclosed in the table below.

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 Pension Plan.

The components of net periodic benefit cost were as follows:

| (Dollars in thousands)                   | SERP<br>Three Months Ended<br>September 30, |        | SERP<br>Nine Months Ended<br>September 30, |        |
|--|---|--------|--|--------|
|  | 2011  | 2010   | 2011                                       | 2010   |
| Net periodic benefit cost for the period |   |        |  |        |
| Service cost                             | \$ 111                                      | \$ 155 | \$ 332                                     | \$ 465 |
| Interest cost                            | 53  | 89     | 161  | 266    |
| Expected return on plan assets           | 0   | 0      | 0  | 0      |
| Amortization of prior service cost       | 0   | 0      | 0  | 0      |
| Recognized actuarial loss                | 0   | 0      | 0  | 0      |
| Recognized curtailment loss              | 0   | 0      | 0  | 0      |
| Net periodic benefit cost                | \$ 164                                      | \$ 244 | \$ 493                                     | \$ 731 |

**(9) Employee Stock Ownership Plan**

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

The loan is secured by the shares purchased with the loan proceeds and will be repaid by the ESOP over the 20-year term of the loan with funds from Territorial Savings Bank's contributions to the ESOP.

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and dividends payable on the shares. The interest rate on the ESOP loan is an adjustable rate equal to the prime rate, as published in The Wall Street Journal. The interest rate adjusts annually and will be the prime rate on the first business day of the calendar year.

Shares purchased by the ESOP are held by a trustee in an unallocated suspense account, and shares are released annually from the suspense account on a pro-rata basis as principal and interest payments are made by the ESOP to the Company. The trustee allocates the shares released among participants on the basis of each participant's proportional share of compensation relative to all participants. As shares are committed to be released from the suspense account, Territorial Savings Bank reports compensation expense based on the average fair value of shares released with a corresponding credit to stockholders' equity. The shares committed to be released are considered outstanding for earnings per share computations. Compensation expense recognized for the three months ended September 30, 2011 and 2010 amounted to \$236,000 and \$212,000, respectively. Compensation expense recognized for the nine months ended September 30, 2011 and 2010 amounted to \$704,000 and \$677,000, respectively.

Shares held by the ESOP trust were as follows:

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Allocated shares                            | 134,564               | 97,865               |
| Unearned shares                             | 844,086               | 880,785              |
| <b>Total ESOP shares</b>                    | <b>978,650</b>        | <b>978,650</b>       |
| Fair value of unearned shares, in thousands | \$ 16,164             | \$ 17,536            |

The ESOP restoration plan is a non-qualified plan that provides supplemental benefits to certain executives who are prevented from receiving the full benefits contemplated by the employee stock ownership plan's benefit formula. The supplemental cash payments consist of payments representing shares that cannot be allocated to the participants under the ESOP due to IRS limitations imposed on tax-qualified plans. We accrue for these benefits over the period during which employees provide services to earn these benefits. For the three months ended September 30, 2011 and 2010, we accrued \$1,000 and \$3,000, respectively, for the ESOP restoration plan. For the nine months ended September 30, 2011 and 2010, we accrued \$159,000 and \$158,000, respectively, for the ESOP restoration plan.

**(10) Share-Based Compensation**

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

Shares of our common stock issued under the Plan shall be authorized but unissued shares. The maximum number of shares that will be awarded under the Plan will be 1,712,637 shares. Share-based compensation expense for the three months and nine months ended September 30, 2011 was \$1.5 million and \$3.0 million, respectively.

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The table below presents the stock option activity for the nine months ended September 30, 2011:

|                               | Options | Weighted<br>average<br>exercise<br>price | Remaining<br>contractual<br>life<br>(years) | Aggregate<br>intrinsic<br>value<br>(in thousands) |
|-------------------------------|---------|--|---|---|
| Balance at December 31, 2010  | 871,144 | \$ 17.36                                 | 9.67  | \$ 2,221  |
| Granted                       | 0       | 0  | 0   | 0   |
| Exercised                     | 0       | 0  | 0   | 0   |
| Forfeited                     | 0       | 0  | 0   | 0   |
| Expired                       | 0       | 0  | 0   | 0   |
| Balance at September 30, 2011 | 871,144 | \$ 17.36                                 | 8.92  | \$ 1,559  |

As of September 30, 2011, the Company had \$3.5 million of unrecognized compensation costs related to stock options. The cost of stock options will be amortized in equal annual installments over the six-year vesting period. There were 179,587 options vested in the nine months ending September 30, 2011.

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

|                                   |          |
|-----------------------------------|----------|
| Expected volatility               | 31.98%   |
| Risk-free interest rate           | 2.58%    |
| Expected dividends                | 1.61%    |
| Expected life (in years)          | 6.75     |
| Grant price for the stock options | \$ 17.36 |

*Expected volatility* - Based on the historical volatility of the Company's stock and a peer group of comparable thrifts.

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

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

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

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

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**Restricted Stock Awards**

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

The table below presents the restricted stock award activity for the six months ended September 30, 2011:

|                                  | Restricted<br>stock awards | Weighted<br>average<br>grant date<br>fair value |
|----------------------------------|----------------------------|---|
| Non-vested at December 31, 2010  | 713,600                    | \$ 17.36  |
| Granted                          | 0                          | 0   |
| Vested                           | 149,606                    | 0   |
| Forfeited                        | 0                          | 0   |
| Non-vested at September 30, 2011 | 563,994                    | \$ 17.36  |

There were 149,606 shares vested in the nine months ending September 30, 2011.

As of September 30, 2011, the Company had \$9.6 million of unrecognized compensation cost related to restricted stock awards. The cost of the restricted stock awards will be amortized in equal annual installments over the six-year vesting period.

**(11) Earnings Per Share**

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

| (Dollars in thousands, except share data)  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2011                                | 2010       | 2011                               | 2010       |
| Net income                                 | \$ 2,986                            | \$ 3,134   | \$ 9,371                           | \$ 7,830   |
| Weighted average number of shares used in: |                                     |            |                                    |            |
| Basic earnings per share                   | 10,659,532                          | 11,334,058 | 10,969,320                         | 11,321,912 |
| Dilutive common stock equivalents:         |                                     |            |                                    |            |
| Stock options and restricted stock units   | 176,117                             | 10,564     | 148,124                            | 34,825     |
| Diluted earnings per share                 | 10,835,649                          | 11,344,622 | 11,117,444                         | 11,356,737 |
| Net income per common share, basic         | \$ 0.28                             | \$ 0.28    | \$ 0.85                            | \$ 0.69    |
| Net income per common share, diluted       | \$ 0.28                             | \$ 0.28    | \$ 0.84                            | \$ 0.69    |

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

In accordance with the Fair Value Measurements and Disclosures topic of the FASB ASC, the Company groups its financial assets and liabilities 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

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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.

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

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

***Cash and Cash Equivalents, Accrued Interest Receivable, Accounts Payable and Accrued Expenses (excluding interest rate contracts), 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 values of U.S. government-sponsored mortgage-backed securities are considered 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.

The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. The trust preferred securities market is considered to be inactive since there have been only five sales transactions of similar rated securities over the past 21 months and no new issues of pooled trust preferred securities have occurred since 2007. The fair value of our trust preferred securities was determined by an independent third-party pricing service which used a discounted cash flow model. Our pricing service used a discount rate of 23.00% and provided a fair value estimate of \$4.75 per \$100 of par value for PreTSL XXIII.

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 three years and a forecast of lower deferral and default rates in later years. The fair value of the trust preferred securities are classified as Level 3 inputs because they are based on discounted cash flow models.

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**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. The fair value of loans is not based on the concept of exit price.

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

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

**Interest Rate Contracts.** The Company may enter into interest rate lock commitments with borrowers on loans intended to be sold. To manage interest rate risk on the lock commitments, the Company may also enter into forward loan sale commitments. The interest rate lock commitments and forward loan sale commitments are treated as derivatives and are recorded at their fair value determined by referring to prices quoted in the secondary market for similar contracts. Interest rate contracts that are classified as assets are included with prepaid expenses and other assets on the consolidated balance sheet while interest rate contracts that are classified as liabilities are included with accounts payable and accrued expenses.

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

| (Dollars in thousands)                                | September 30, 2011 |                      | December 31, 2010 |                      |
|---|--------------------|----------------------|-------------------|----------------------|
|   | Carrying amount    | Estimated fair value | Carrying amount   | Estimated fair value |
| <b>Assets</b>   |                    |                      |                   |                      |
| Cash and cash equivalents                             | \$ 132,448         | 132,448              | 194,435           | 194,435              |
| Investment securities available for sale              | 0                  | 0                    | 15,010            | 15,010               |
| Investment securities held to maturity                | 658,574            | 694,996              | 530,555           | 546,844              |
| FHLB stock  | 12,348             | 12,348               | 12,348            | 12,348               |
| Loans held for sale                                   | 2,987              | 3,093                | 3,234             | 3,234                |
| Loans receivable, net                                 | 662,734            | 764,118              | 641,790           | 666,339              |
| Accrued interest receivable                           | 4,882              | 4,882                | 4,536             | 4,536                |
| Interest rate contracts                               | 199                | 199                  | 456               | 456                  |
| <b>Liabilities</b>                                    |                    |                      |                   |                      |
| Deposits  | \$ 1,139,317       | 1,141,523            | 1,076,470         | 1,078,590            |
| Advances from the Federal Home Loan Bank              | 20,000             | 20,637               | 10,000            | 10,274               |
| Securities sold under agreement to repurchase         | 120,200            | 125,103              | 105,200           | 109,953              |
| Accounts payable and accrued expenses                 | 19,549             | 19,549               | 20,116            | 20,116               |
| Interest rate contracts                               | 178                | 178                  | 314               | 314                  |
| Current income taxes payable                          | 416                | 416                  | 577               | 577                  |
| Advance payments by borrowers for taxes and insurance | 2,088              | 2,088                | 3,376             | 3,376                |



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At September 30, 2011 and December 31, 2010, neither the commitment fees received on commitments to extend credit nor the fair value thereof was material to the consolidated financial statements of the Company.

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

| (Dollars in thousands)         |             | Level 1 | Level 2 | Level 3 | Total  |
|--------------------------------|-------------|---------|---------|---------|--------|
| <b>September 30, 2011</b>      |             |         |         |         |        |
| Interest rate contracts        | assets      | \$ 0    | 199     | 0       | 199    |
| Interest rate contracts        | liabilities | 0       | (178)   | 0       | (178)  |
| <b>December 31, 2010</b>       |             |         |         |         |        |
| Interest rate contracts        | assets      | \$ 0    | 456     | 0       | 456    |
| Interest rate contracts        | liabilities | 0       | (314)   | 0       | (314)  |
| Available-for-sale investments |             | 0       | 15,010  | 0       | 15,010 |

The fair value of interest rate contracts was determined by referring to prices quoted in the secondary market for similar contracts. Gains and losses are included in gain on sale of loans in the consolidated statements of income. The fair value of available-for-sale investments was determined using quoted market prices for similar investments. The losses, net of taxes, are included in accumulated other comprehensive loss in the consolidated balance sheets.

The table below presents the balance of assets measured at fair value on a nonrecurring basis and the related gains and losses for the nine months ended September 30, 2011 and the year ended December 31, 2010:

| (Dollars in thousands)     | Level 1 | Level 2 | Level 3 | Total | Total Gains (Losses) |
|----------------------------|---------|---------|---------|-------|----------------------|
| <b>September 30, 2011</b>  |         |         |         |       |                      |
| Impaired loans             | \$ 0    | 0       | 2,425   | 2,425 | 1                    |
| Mortgage servicing assets  | 0       | 0       | 1,008   | 1,008 | (32)                 |
| <b>December 31, 2010</b>   |         |         |         |       |                      |
| Impaired loans             | \$ 0    | 254     | 2,429   | 2,683 | (183)                |
| Trust preferred securities | 0       | 0       | 128     | 128   | (2,404)              |
| Mortgage servicing assets  | 0       | 0       | 1,366   | 1,366 | (64)                 |

The fair value of impaired loans that are considered to be collateral dependent is determined using the value of collateral less estimated selling costs. The fair value of impaired loans that are not

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considered to be collateral dependent is determined based on the present value of expected future cash flows discounted at the loan's effective interest rate. Gains and losses on impaired loans are included in the provision for loan losses in the consolidated statements of income. The fair value of trust preferred securities was determined by an independent third-party pricing service using a discounted cash flow model. The assumptions used in the discounted cash flow model are discussed above. Losses on trust preferred securities are included in net other-than-temporary impairment losses in the consolidated statements of income. Mortgage servicing assets are valued using a cash flow model prepared by an independent third-party appraiser. Assumptions used in the model include mortgage prepayment speeds, discount rates, cost of servicing and ancillary income. Losses on mortgage servicing assets are included in service fees on loan and deposit accounts in the consolidated statements of income.

**(13) Subsequent Events**

On October 13, 2011, Territorial Bancorp Inc. announced that it completed its second repurchase program. The Company repurchased 581,265 shares of its common stock at an average price of \$19.22 per share.

On November 3, 2011, the Board of Directors of Territorial Bancorp Inc. declared a quarterly cash dividend of \$0.09 per share of common stock. The dividend is expected to be paid on December 1, 2011 to stockholders of record as of November 17, 2011.

**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;

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competition among depository and other financial institutions;

inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;

adverse changes in the securities markets;

changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;

our ability to enter new markets successfully and capitalize on growth opportunities;

our ability to successfully integrate acquired entities, if any;

changes in consumer spending, borrowing and savings habits;

changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board;

changes in our organization, compensation and benefit plans;

changes in our financial condition or results of operations that reduce capital available to pay dividends; and

changes in the financial condition or future prospects of issuers of securities that we own.

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

**Critical Accounting Policies**

There are no material changes to the critical accounting policies disclosed in Territorial Bancorp Inc.'s Annual Report on Form 10-K for the year ended December 31, 2010.

**Comparison of Financial Condition at September 30, 2011 and December 31, 2010**

**Assets.** At September 30, 2011, our assets were \$1.516 billion, an increase of \$72.6 million, or 5.0%, from \$1.443 billion at December 31, 2010. The growth in assets was primarily the result of increases in investment securities and loans receivable, which were partially offset by a decrease in cash and cash equivalents.

**Cash and Cash Equivalents.** Cash and cash equivalents were \$132.4 million at September 30, 2011, a decrease of \$62.0 million since December 31, 2010. Cash and cash equivalents, along with the



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proceeds from a \$62.8 million increase in deposits and a \$25.0 million increase in borrowings, were primarily used to fund an increase of \$113.0 million in investment securities and \$20.7 million in total loans, repurchase Company shares costing \$23.5 million, and pay dividends of \$2.7 million to common shareholders.

**Loans.** Total loans, including \$3.0 million of loans held for sale, were \$665.7 million at September 30, 2011, or 43.9% of total assets. During the nine months ended September 30, 2011, the loan portfolio increased by \$20.7 million, or 3.2%. The increase in the loan portfolio occurred as one- to four-family residential loan production exceeded principal repayments and loan sales.

**Securities.** At September 30, 2011, our securities portfolio totaled \$658.6 million, or 43.4% of assets. At September 30, 2011, 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 non-conforming loans having less than full documentation) loans. During the nine months ended September 30, 2011, our securities portfolio increased by \$113.0 million, or 20.7%, primarily due to purchases exceeding repayments.

\$15.0 million of U.S. government-sponsored mortgage-backed securities were reclassified from available-for-sale to held-to-maturity during the nine months ended September 30, 2011. Management considers the held-to-maturity classification of these securities to be appropriate as the Company has the positive intent and ability to hold these securities to maturity.

At September 30, 2011, we owned trust preferred securities with a carrying value of \$32,000. 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. The difference between the carrying value of \$32,000 and the remaining amortized cost basis of \$1.1 million is included as a component of accumulated other comprehensive loss, net of taxes, and is related to non-credit factors such as the trust preferred securities market being inactive.

The trust preferred securities market is considered inactive as only five sales transactions of similarly rated securities have occurred over the past 21 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 whether they are other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates (using yields of comparable traded instruments adjusted for illiquidity and other risk factors), estimated deferral and default rates on collateral, and estimated cash flows.

Based on the Company's review, the Company's investment in trust preferred securities did not incur additional impairment during the quarter ending September 30, 2011 as the present value of cash flows exceeded the amortized cost basis of \$1.1 million.

At September 30, 2011, PreTSL XXIII and XXIV are rated C by Fitch.

It is reasonably possible that the fair values of the trust preferred securities could decline in the near term if the overall economy and the financial condition of some of the issuers continue to deteriorate and the liquidity of these securities remains low. As a result, there is a risk that the Company's amortized cost basis of \$1.1 million on its trust preferred securities could become other-than-temporarily impaired in the near term. Any such impairment could be material to the Company's consolidated statements of income.

**Deposits.** Deposits were \$1.139 billion at September 30, 2011, an increase of \$62.8 million, or 5.8%, since December 31, 2010. The increase in deposits was caused by opening two new branches and our continuing to promote higher-than-market rates for savings accounts.

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***Borrowings.*** During the nine months ended September 30, 2011, our borrowings increased by \$25.0 million, or 21.7%, to \$140.2 million, due to a \$15.0 million net increase in securities sold under agreements to repurchase and a \$10.0 million increase in Federal Home Loan Bank advances. The increase in long-term borrowings was part of the Bank's strategy to control interest rate risk.

***Stockholders' Equity.*** Stockholders' equity was \$214.2 million at September 30, 2011, a decrease of \$13.1 million, or 5.8%, since December 31, 2010. The decrease in stockholders' equity occurred primarily because of the repurchase of shares costing \$23.5 million and the payment of \$2.7 million of dividends to shareholders. This decrease in stockholders' equity was offset by current year's earnings of \$9.4 million and a \$2.8 million increase in paid-in-capital related to stock benefit plans.

**Average Balances and Yields**

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

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|  | For the Three Months Ended September 30, |           |  |                                   |           |                    |
|--|--|-----------|--|-----------------------------------|-----------|--------------------|
|  | 2011                                     |           |  | 2010                              |           |                    |
|  | Average<br>Outstanding<br>Balance        | Interest  | Yield/<br>Rate (1)<br>(Dollars in thousands) | Average<br>Outstanding<br>Balance | Interest  | Yield/<br>Rate (1) |
| <b>Interest-earning assets:</b>                          |  |           |  |                                   |           |                    |
| Loans:   |  |           |  |                                   |           |                    |
| Real estate loans:                                       |  |           |  |                                   |           |                    |
| First mortgage:  |  |           |  |                                   |           |                    |
| One- to four-family residential (5)                      | \$ 618,576                               | \$ 8,127  | 5.26%  | \$ 585,520                        | \$ 8,154  | 5.57%              |
| Multi-family residential                                 | 6,082                                    | 97        | 6.38   | 5,012                             | 84        | 6.70               |
| Construction, commercial and other                       | 14,512                                   | 217       | 5.98   | 16,972                            | 260       | 6.13               |
| Home equity loans and lines of credit                    | 18,052                                   | 272       | 6.03   | 20,491                            | 317       | 6.19               |
| Other loans  | 5,244                                    | 85        | 6.48   | 6,112                             | 92        | 6.02               |
| Total loans  | 662,466                                  | 8,798     | 5.31   | 634,107                           | 8,907     | 5.62               |
| Investment securities:                                   |  |           |  |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities (5) | 648,645                                  | 6,907     | 4.26   | 569,364                           | 6,371     | 4.48               |
| Trust preferred securities                               | 32                                       |           |  | 31                                |           |                    |
| Total securities   | 648,677                                  | 6,907     | 4.26   | 569,395                           | 6,371     | 4.48               |
| Other  | 154,679                                  | 85        | 0.22   | 201,910                           | 115       | 0.23               |
| Total interest-earning assets                            | 1,465,822                                | 15,790    | 4.31   | 1,405,412                         | 15,393    | 4.38               |
| Non-interest-earning assets                              | 51,035                                   |           |  | 50,468                            |           |                    |
| Total assets   | \$ 1,516,857                             |           |  | \$ 1,455,880                      |           |                    |
| <b>Interest-bearing liabilities:</b>                     |  |           |  |                                   |           |                    |
| Savings accounts   | \$ 776,218                               | \$ 1,178  | 0.61%  | \$ 745,040                        | \$ 1,887  | 1.01%              |
| Certificates of deposit                                  | 222,619                                  | 510       | 0.92   | 222,001                           | 653       | 1.18               |
| Money market accounts                                    | 510                                      | 1         | 0.78   | 504                               |           |                    |
| Checking and Super NOW accounts                          | 106,229                                  | 11        | 0.04   | 101,128                           | 15        | 0.06               |
| Total interest-bearing deposits                          | 1,105,576                                | 1,700     | 0.62   | 1,068,673                         | 2,555     | 0.96               |
| Federal Home Loan Bank advances                          | 20,001                                   | 105       | 2.10   | 9,999                             | 54        | 2.16               |
| Other borrowings   | 119,927                                  | 1,067     | 3.56   | 105,199                           | 1,070     | 4.07               |
| Total interest-bearing liabilities                       | 1,245,504                                | 2,872     | 0.92   | 1,183,871                         | 3,679     | 1.24               |
| Non-interest-bearing liabilities                         | 48,860                                   |           |  | 46,722                            |           |                    |
| Total liabilities  | 1,294,364                                |           |  | 1,230,593                         |           |                    |
| Stockholders' equity                                     | 222,494                                  |           |  | 225,287                           |           |                    |
| Total liabilities and stockholders' equity               | \$ 1,516,858                             |           |  | \$ 1,455,880                      |           |                    |
| Net interest income                                      |  | \$ 12,918 |  |                                   | \$ 11,714 |                    |
| Net interest rate spread (2)                             |  |           | 3.39%  |                                   |           | 3.14%              |
| Net interest-earning assets (3)                          | \$ 220,318                               |           |  | \$ 221,541                        |           |                    |
| Net interest margin (4)                                  |  |           | 3.53%  |                                   |           | 3.33%              |
| Interest-earning assets to interest-bearing liabilities  | 117.69%                                  |           |  | 118.71%                           |           |                    |

## Edgar Filing: Territorial Bancorp Inc. - Form 10-Q

- (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 represent total interest-earning assets less total interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average total interest-earning assets.
- (5) Average balance includes loans or investments available for sale.



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|  | For the Nine Months Ended September 30, |           |  |                                   |           |                    |
|--|---|-----------|--|-----------------------------------|-----------|--------------------|
|  | 2011                                    |           |  | 2010                              |           |                    |
|  | Average<br>Outstanding<br>Balance       | Interest  | Yield/<br>Rate (1)<br>(Dollars in thousands) | Average<br>Outstanding<br>Balance | Interest  | Yield/<br>Rate (1) |
| <b>Interest-earning assets:</b>                          |   |           |  |                                   |           |                    |
| Loans:   |   |           |  |                                   |           |                    |
| Real estate loans:                                       |   |           |  |                                   |           |                    |
| First mortgage:  |   |           |  |                                   |           |                    |
| One- to four-family residential (5)                      | \$ 614,515                              | \$ 24,400 | 5.29%  | \$ 567,996                        | \$ 23,676 | 5.56%              |
| Multi-family residential                                 | 6,090                                   | 293       | 6.41   | 4,497                             | 230       | 6.82               |
| Construction, commercial and other                       | 14,246                                  | 644       | 6.03   | 17,145                            | 821       | 6.38               |
| Home equity loans and lines of credit                    | 18,636                                  | 850       | 6.08   | 21,062                            | 991       | 6.27               |
| Other loans  | 5,374                                   | 257       | 6.38   | 6,395                             | 300       | 6.25               |
| Total loans  | 658,861                                 | 26,444    | 5.35   | 617,095                           | 26,018    | 5.62               |
| Investment securities:                                   |   |           |  |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities (5) | 627,718                                 | 20,167    | 4.28   | 583,492                           | 19,819    | 4.53               |
| Trust preferred securities                               | 32                                      |           |  | 1,176                             |           |                    |
| Total securities   | 627,750                                 | 20,167    | 4.28   | 584,668                           | 19,819    | 4.52               |
| Other  | 157,126                                 | 258       | 0.22   | 174,976                           | 290       | 0.22               |
| Total interest-earning assets                            | 1,443,737                               | 46,869    | 4.33   | 1,376,739                         | 46,127    | 4.47               |
| Non-interest-earning assets                              | 50,322                                  |           |  | 50,093                            |           |                    |
| Total assets   | \$ 1,494,059                            |           |  | \$ 1,426,832                      |           |                    |
| <b>Interest-bearing liabilities:</b>                     |   |           |  |                                   |           |                    |
| Savings accounts   | \$ 763,819                              | \$ 3,540  | 0.62%  | \$ 706,694                        | \$ 6,397  | 1.21%              |
| Certificates of deposit                                  | 214,755                                 | 1,528     | 0.95   | 234,419                           | 2,043     | 1.16               |
| Money market accounts                                    | 587                                     | 2         | 0.45   | 25,262                            | 12        | 0.06               |
| Checking and Super NOW accounts                          | 106,711                                 | 39        | 0.05   | 76,254                            | 32        | 0.06               |
| Total interest-bearing deposits                          | 1,085,872                               | 5,109     | 0.63   | 1,042,629                         | 8,484     | 1.08               |
| Federal Home Loan Bank advances                          | 18,901                                  | 295       | 2.08   | 6,300                             | 99        | 2.10               |
| Other borrowings   | 115,075                                 | 3,153     | 3.65   | 106,834                           | 3,211     | 4.01               |
| Total interest-bearing liabilities                       | 1,219,848                               | 8,557     | 0.94   | 1,155,763                         | 11,794    | 1.36               |
| Non-interest-bearing liabilities                         | 47,837                                  |           |  | 47,875                            |           |                    |
| Total liabilities  | 1,267,685                               |           |  | 1,203,638                         |           |                    |
| Stockholders' equity                                     | 226,374                                 |           |  | 223,194                           |           |                    |
| Total liabilities and stockholders' equity               | \$ 1,494,059                            |           |  | \$ 1,426,832                      |           |                    |
| Net interest income                                      |   | \$ 38,312 |  |                                   | \$ 34,333 |                    |
| Net interest rate spread (2)                             |   |           | 3.39%  |                                   |           | 3.11%              |
| Net interest-earning assets (3)                          | \$ 223,889                              |           |  | \$ 220,976                        |           |                    |
| Net interest margin (4)                                  |   |           | 3.54%  |                                   |           | 3.33%              |
| Interest-earning assets to interest-bearing liabilities  | 118.35%                                 |           |  | 119.12%                           |           |                    |

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- (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 represent total interest-earning assets less total interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average total interest-earning assets.
- (5) Average balance includes loans or investments available for sale.

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**Table of Contents****Comparison of Operating Results for the Three Months Ended September 30, 2011 and 2010**

**General.** Net income decreased by \$148,000, or 4.7%, to \$3.0 million for the three months ended September 30, 2011 from \$3.1 million for the three months ended September 30, 2010. The decrease in net income was caused by a \$1.6 million increase in non-interest expense, which included \$696,000 of stock benefit plan expenses which we recognized due to the death of a director. This was partially offset by an \$807,000 decrease in interest expense, a \$397,000 increase in interest and dividend income, a \$157,000 decrease in provision for loan losses, and a \$125,000 increase in non-interest income.

**Net Interest Income.** Net interest income increased by \$1.2 million, or 10.3%, to \$12.9 million for the three months ended September 30, 2011 compared to \$11.7 million for the three months ended September 30, 2010. Interest expense decreased by \$807,000, or 21.9%, due to a 32 basis point decrease in the average cost of interest-bearing liabilities, which was partially offset by a \$61.6 million increase in the average balance of interest-bearing liabilities. Interest and dividend income increased by \$397,000, or 2.6%, due primarily to a \$60.4 million increase in the average balance of interest-earning assets, which was partially offset by a seven basis point decrease in the average yield on interest-earning assets. The interest rate spread and net interest margin were 3.39% and 3.53%, respectively, for the three months ended September 30, 2011, compared to 3.14% and 3.33%, respectively, for the three months ended September 30, 2010.

**Interest and Dividend Income.** Interest and dividend income increased by \$397,000, or 2.6%, to \$15.8 million for the three months ended September 30, 2011 from \$15.4 million for the three months ended September 30, 2010. Interest income on investment securities increased by \$536,000, or 8.4%, to \$6.9 million for the three months ended September 30, 2011 from \$6.4 million for the three months ended September 30, 2010. The increase in interest income on securities occurred primarily because of a \$79.3 million increase in the average balance of investment securities, which was partially offset by a 22 basis point decrease in the average yield on securities. The decrease in yield occurred as higher-yielding mortgage-backed securities were repaid and the Company purchased new mortgage-backed securities that had lower yields. The decrease in yields on the mortgage-backed securities purchased occurred because of a reduction in long-term mortgage rates. Interest income on loans decreased by \$109,000, or 1.2%, to \$8.8 million for the three months ended September 30, 2011 from \$8.9 million for the three months ended September 30, 2010. The decrease in interest income on loans occurred because of a 31 basis point decline in the average loan yield to 5.31% for the three months ended September 30, 2011. The decline in the average yield on loans occurred because of repayments on higher-yielding loans while new loans with lower yields were added to the loan portfolio. The decrease in interest income that occurred because of a decline in yield was partially offset by a \$28.4 million, or 4.5%, increase in the average balance of loans as new loan originations exceeded loan repayments and loan sales.

**Interest Expense.** Interest expense decreased by \$807,000, or 21.9%, to \$2.9 million for the three months ended September 30, 2011 compared to \$3.7 million for the three months ended September 30, 2010. Interest expense on deposits decreased \$855,000, or 33.5%, to \$1.7 million for the three months ended September 30, 2011 from \$2.6 million for the three months ended September 30, 2010. During the three months ended September 30, 2011, interest expense on savings accounts and certificates of deposit declined by \$709,000 and \$143,000, respectively. During the three months ended September 30, 2011, the average interest rate on savings accounts and certificates of deposit decreased by 40 and 26 basis points, respectively. We lowered the rates we pay on savings accounts and certificates of deposit due to declining market interest rates.

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**Provision for Loan Losses.** We recorded a reversal of provisions for loan losses of \$39,000 for the three months ended September 30, 2011 as compared to a provision for loan losses of \$118,000 for the three months ended September 30, 2010. The reversal of provisions made during the three months ended September 30, 2011 is primarily due to a \$1.2 million decrease in the construction, commercial and other loan portfolio. Non-performing loans totaled \$2.4 million at September 30, 2011, or 0.36% of total loans at that date, compared to \$509,000 of non-performing loans at September 30, 2010, or 0.08% of total loans at that date. Non-performing loans as of September 30, 2011 and 2010 consisted primarily of one- to four-family residential real estate loans. The provisions made during the three months ended September 30, 2010 included specific reserves of \$274,000 related to \$368,000 of loans consisting of two one- to four-family residential real estate loans and one commercial loan. This was partially offset by the reversal of an \$84,000 write down on a restructured loan that was paid off and a reduction in the general loan loss provision of \$80,000 in the three months ended September 30, 2010. We experienced charge offs of \$7,000 and \$378,000 and recoveries of \$6,000 and \$94,000 for the three months ended September 30, 2011 and 2010, respectively. The allowance for loan losses to total loans was 0.23% and 0.25% at September 30, 2011 and 2010, respectively. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2011 and 2010.

**Non-Interest Income.** The following table summarizes changes in non-interest income between the three months ended September 30, 2011 and 2010.

|   | Three Months Ended |                    | Change    |          |
|---|--------------------|--------------------|-----------|----------|
|   | September 30, 2011 | September 30, 2010 | \$ Change | % Change |
|   | (In thousands)     |                    |           |          |
| Service fees on loan and deposit accounts | \$ 534             | \$ 546             | \$ (12)   | (2.2)%   |
| Income on bank-owned life insurance       | 245                | 256                | (11)      | (4.3)%   |
| Gain on sale of investment securities     | 74                 |                    | 74        | N/A      |
| Gain on sale of loans                     | 138                | 165                | (27)      | (16.4)%  |
| Other                                     | 177                | 76                 | 101       | 132.9%   |
| Total                                     | \$ 1,168           | \$ 1,043           | \$ 125    | 12.0%    |

Non-interest income increased by \$125,000 for the three months ended September 30, 2011. During the three months ended September 30, 2011, the Company realized gains of \$74,000 from sales of securities. During the three months ended September 30, 2010, we did not sell any investment securities. Other non-interest income was \$177,000 for the quarter ended September 30, 2011 compared to \$76,000 for the quarter ended September 30, 2010. The increase in other non-interest income is primarily due to a \$97,000 increase in commissions from the sale of non-deposit products.

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**Non-Interest Expense.** The following table summarizes changes in non-interest expense between the three months ended September 30, 2011 and 2010.

|   | Three Months<br>Ended<br>September 30, |          | Change    |          |
|---|--|----------|-----------|----------|
|   | 2011                                   | 2010     | \$ Change | % Change |
|   | (In thousands)                         |          |           |          |
| Salaries and employee benefits            | \$ 6,017                               | \$ 4,526 | \$ 1,491  | 32.9%    |
| Occupancy                                 | 1,267                                  | 1,146    | 121       | 10.6%    |
| Equipment                                 | 792                                    | 734      | 58        | 7.9%     |
| Federal deposit insurance premiums        | 191                                    | 308      | (117)     | (38.0)%  |
| Other general and administrative expenses | 954                                    | 952      | 2         | 0.2%     |
| Total                                     | \$ 9,221                               | \$ 7,666 | \$ 1,555  | 20.3%    |

Non-interest expense rose by \$1.6 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010. Salaries and employee benefits increased for the three months ended September 30, 2011 primarily because of a \$1.2 million increase in expenses accrued for the equity incentive plan that was approved by the shareholders in August 2010. Included in the \$1.2 million increase in expenses is \$696,000 of stock benefit plan expenses which the Company recognized when a director passed away. In addition, the Company incurred a bank-wide budgeted salary increase of approximately 2.0%, which was effective July 1, 2011.

**Income Tax Expense.** Income taxes were \$1.9 million for the three months ended September 30, 2011, reflecting an effective tax rate of 39.1% compared to \$1.8 million for the three months ended September 30, 2010, reflecting an effective tax rate of 37.0%. The increase in the effective tax rate for the three months ended September 30, 2011 is primarily due to consistent amounts of non-taxable income received from bank-owned life insurance relative to an increase in pre-tax income and adjustments made during the three months ended September 30, 2011 to reflect an increase in the estimate of taxes we will pay for the year ending December 31, 2011.

**Comparison of Operating Results for the Nine Months Ended September 30, 2011 and 2010**

**General.** Net income increased by \$1.5 million, or 19.7%, to \$9.4 million for the nine months ended September 30, 2011 from \$7.8 million for the nine months ended September 30, 2010. The increase in net income was primarily caused by a \$3.2 million decrease in interest expense, a \$2.3 million increase in non-interest income, a \$742,000 increase in interest and dividend income, and a \$193,000 decrease in provision for loan losses. This was partially offset by a \$3.4 million increase in non-interest expense and a \$1.6 million increase in income taxes.

**Net Interest Income.** Net interest income increased by \$4.0 million, or 11.6%, to \$38.3 million for the nine months ended September 30, 2011 compared to \$34.3 million for the nine months ended September 30, 2010. Interest expense decreased by \$3.2 million, or 27.4%, due to a 42 basis point decrease in the average cost of interest-bearing liabilities, which was partially offset by a \$64.1 million increase in the average balance of interest-bearing liabilities. Interest and dividend income increased by \$742,000, or 1.6%, due primarily to a \$67.0 million increase in the average balance of interest-earning assets, which was offset by 14 basis point decrease in the average yield on interest-earning assets. The interest rate spread and net interest margin were 3.39% and 3.54%, respectively, for the nine months ended September 30, 2011, compared to 3.11% and 3.33%, respectively, for the nine months ended September 30, 2010.

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**Interest and Dividend Income.** Interest and dividend income increased by \$742,000, or 1.6%, to \$46.9 million for the nine months ended September 30, 2011 from \$46.1 million for the nine months ended September 30, 2010. Interest income on loans increased by \$426,000, or 1.6%, to \$26.4 million for the nine months ended September 30, 2011 from \$26.0 million for the nine months ended September 30, 2010. The increase in interest income on loans occurred because the average balance of loans grew by \$41.8 million, or 6.8%, as new loan originations exceeded loan repayments and loan sales. The increase in interest income which occurred because of growth in the loan portfolio was partially offset by a 27 basis point decline in the average loan yield to 5.35% for the nine months ended September 30, 2011. The decline in the average yield on loans occurred because of repayments on higher-yielding loans while new loans with lower yields were added to the loan portfolio. In addition to the increase in interest income on loans, interest income on investment securities increased \$348,000, or 1.8%, to \$20.2 million for the nine months ended September 30, 2011 from \$19.8 million for the nine months ended September 30, 2010. The increase in interest income on securities occurred primarily because of a \$43.1 million increase in the average securities balance due to the purchase of government-sponsored mortgage-backed securities. The increase in the average securities balance was partially offset by a 24 basis point decrease in the average yield on securities. The decrease in yield occurred as higher-yielding mortgage-backed securities were repaid and the Company purchased new mortgage-backed securities that had lower yields. The decrease in yields on the mortgage-backed securities purchased occurred because of a drop in long-term mortgage rates.

**Interest Expense.** Interest expense decreased by \$3.2 million, or 27.4%, to \$8.6 million for the nine months ended September 30, 2011 compared to \$11.8 million for the nine months ended September 30, 2010. Interest expense on deposits decreased \$3.4 million, or 39.8%, to \$5.1 million for the nine months ended September 30, 2011 from \$8.5 million for the nine months ended September 30, 2010. During the nine months ended September 30, 2011, interest expense on savings accounts and certificates of deposit declined by \$2.9 million and \$515,000, respectively. During the nine months ended September 30, 2011, the average interest rate on savings accounts and certificates of deposit decreased by 59 and 21 basis points, respectively. We lowered the rates we pay on savings accounts and certificates of deposit due to declining market interest rates and increased liquidity from principal repayments on loans and mortgage-backed securities.

**Provision for Loan Losses.** We recorded provisions for loan losses of \$83,000 and \$276,000 for the nine months ended September 30, 2011 and 2010, respectively. The provisions made during the nine months ended September 30, 2011 included \$64,000 of general loan loss provisions due to the increase in non-performing loans. The provision made during the nine months ended September 30, 2010 included specific reserves of \$415,000 related to \$936,000 of loans consisting of four one- to four-family residential real estate loans and two commercial loans. This was partially offset by the reversal of an \$84,000 write down on a restructured loan that was paid off and a reduction in general reserves of \$50,000. Non-performing loans totaled \$2.4 million at September 30, 2011, or 0.36% of total loans at that date, compared to \$509,000 of non-performing loans at September 30, 2010, or 0.08% of total loans at that date. Non-performing loans as of September 30, 2011 and 2010 consisted primarily of one- to four-family residential real estate loans. We experienced charge offs of \$62,000 and \$501,000 and recoveries of \$43,000 and \$115,000 for the nine months ended September 30, 2011 and 2010, respectively. The allowance for loan losses to total loans was 0.23% and 0.25% at September 30, 2011 and 2010, respectively. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2011 and 2010.

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**Non-Interest Income.** The following table summarizes changes in non-interest income between the nine months ended September 30, 2011 and 2010.

|  | Nine Months Ended<br>September 30, |                 | Change          |               |
|--|------------------------------------|-----------------|-----------------|---------------|
|  | 2011                               | 2010            | \$ Change       | % Change      |
|  | (In thousands)                     |                 |                 |               |
| Other-than-temporary impairment loss on investments, net | \$                                 | \$ (2,404)      | \$ 2,404        | 100.0%        |
| Service fees on loan and deposit accounts                | 1,690                              | 1,834           | (144)           | (7.9)%        |
| Income on bank-owned life insurance                      | 725                                | 765             | (40)            | (5.2)%        |
| Gain on sale of investment securities                    | 140                                | 350             | (210)           | (60.0)%       |
| Gain on sale of loans                                    | 374                                | 420             | (46)            | (11.0)%       |
| Other  | 588                                | 224             | 364             | 162.5%        |
| <b>Total</b>   | <b>\$ 3,517</b>                    | <b>\$ 1,189</b> | <b>\$ 2,328</b> | <b>195.8%</b> |

Non-interest income rose by \$2.3 million for the nine months ended September 30, 2011. We recognized a \$2.4 million loss for other-than-temporary impairment on our investments in trust preferred securities during the nine months ended September 30, 2010. In the nine months ended September 30, 2011, we did not incur any other-than-temporary impairment loss on our investments. See Comparison of Financial Condition at September 30, 2011 and December 31, 2010 Securities for a discussion of these securities. For the nine months ended September 30, 2011 and 2010, we recognized gains of \$140,000 and \$350,000, respectively, on the sale of investment securities. Other non-interest income was \$588,000 for the nine months ended September 30, 2011 compared to \$224,000 for the nine months ended September 30, 2010. The increase in other non-interest income is primarily due to a legal settlement of an insurance claim in the amount of \$194,000 and a \$162,000 increase in commissions from the sale of non-deposit products.

**Non-Interest Expense.** The following table summarizes changes in non-interest expense between the nine months ended September 30, 2011 and 2010.

|   | Nine Months Ended<br>September 30, |                  | Change          |              |
|---|------------------------------------|------------------|-----------------|--------------|
|   | 2011                               | 2010             | \$ Change       | % Change     |
|   | (In thousands)                     |                  |                 |              |
| Salaries and employee benefits            | \$ 16,630                          | \$ 13,533        | \$ 3,097        | 22.9%        |
| Occupancy                                 | 3,714                              | 3,428            | 286             | 8.3%         |
| Equipment                                 | 2,366                              | 2,184            | 182             | 8.3%         |
| Federal deposit insurance premiums        | 678                                | 898              | (220)           | (24.5)%      |
| Other general and administrative expenses | 2,887                              | 2,843            | 44              | 1.5%         |
| <b>Total</b>                              | <b>\$ 26,275</b>                   | <b>\$ 22,886</b> | <b>\$ 3,389</b> | <b>14.8%</b> |

Non-interest expense rose by \$3.4 million during the nine months ended September 30, 2011. Salaries and employee benefits increased for the nine months ended September 30, 2011 primarily because of a \$2.7 million increase in expenses accrued for the equity incentive plan that was approved by the shareholders in August 2010. During the nine months ended September 30, 2011, the Company recognized \$696,000 of stock benefit plan expense when a director passed away. In addition, the Company incurred a bank-wide budgeted salary increase of approximately 2.0%, which was effective July 1, 2011.

**Income Tax Expense.** Income taxes were \$6.1 million for the nine months ended September 30, 2011, reflecting an effective tax rate of 39.4% compared to \$4.5 million for the nine months ended





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September 30, 2010, reflecting an effective tax rate of 36.7%. The increase in the effective tax rate for the nine months ended September 30, 2011 is primarily due to consistent amounts of non-taxable income received from bank-owned life insurance relative to an increase in pre-tax income and adjustments made during the nine months ended September 30, 2011 to reflect an increase in the estimate of taxes we will pay for the year ending December 31, 2011.

### **Liquidity and Capital Resources**

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, cash balances at the Federal Reserve Bank, loan repayments, advances from the Federal Home Loan Bank of Seattle, borrowings using securities sold under agreements to repurchase, maturities and principal repayments on held-to-maturity and available-for-sale securities and the sale of available-for-sale securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We have established an Asset/Liability Management Committee, consisting of our Chairman of the Board, President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Treasurer and our Vice President and Controller, which is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of September 30, 2011.

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

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

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

Our most liquid asset is cash and cash equivalents. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2011, cash and cash equivalents totaled \$132.4 million. On that date, we had \$20.0 million of Federal Home Loan Bank advances outstanding and \$120.2 million in securities sold under agreements to repurchase outstanding, with the ability to borrow an additional \$352.6 million under Federal Home Loan Bank advances.

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

At September 30, 2011, we had \$26.5 million in loan commitments outstanding, most of which were for fixed-rate loans. In addition to commitments to originate loans, we had \$19.0 million in unused lines of credit to borrowers as of September 30, 2011. Certificates of deposit due within one year at September 30, 2011 totaled \$179.4 million, or 15.7% of total deposits. If these deposits do not remain

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with us, we may be required to seek other sources of funds, including loan sales, brokered deposits, securities sold under agreements to repurchase and Federal Home Loan Bank advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before September 30, 2012. We believe, however, based on past experience that a portion of such deposits will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

Our primary investing activities are originating loans and purchasing mortgage-backed securities. During the three months ended September 30, 2011 and 2010, we originated \$41.1 million and \$63.6 million of loans, respectively, and purchased \$45.4 million and \$51.2 million of securities, respectively. During the nine months ended September 30, 2011 and 2010, we originated \$146.3 million and \$141.9 million of loans, respectively, and purchased \$211.3 million and \$81.7 million of securities, respectively.

Financing activities consist primarily of activity in deposit accounts, Federal Home Loan Bank advances and securities sold under agreements to repurchase. We experienced net increases in deposits of \$62.8 million and \$64.2 million for the nine months ended September 30, 2011 and 2010, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the Federal Home Loan Bank of Seattle, which provide an additional source of funds. We also utilize securities sold under agreements to repurchase as another borrowing source. Federal Home Loan Bank advances increased by \$10.0 million for the nine months ended September 30, 2011. We had the ability to borrow up to an additional \$352.6 million and \$351.7 million from the Federal Home Loan Bank of Seattle as of September 30, 2011 and 2010, respectively. Securities sold under agreements to repurchase increased by \$15.0 million for the nine months ended September 30, 2011, compared to a decrease of \$25.0 million for the nine months ended September 30, 2010. Borrowings were obtained to control interest rate risk.

Territorial Savings Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At September 30, 2011, Territorial Savings Bank exceeded all regulatory capital requirements. Territorial Savings Bank is considered well capitalized under regulatory guidelines. The tables below present the capital required as a percentage of total and risk-weighted assets and the percentage and the total amount of capital maintained at September 30, 2011 and December 31, 2010.

**As of September 30, 2011**

(Dollars in thousands)

|                           | Required | Territorial Savings Bank |        |
|---------------------------|----------|--------------------------|--------|
| Tier 1 Capital            | 4%       | \$ 200,095               | 13.12% |
| Total Risk-Based Capital  | 8%       | \$ 201,647               | 39.01% |
| Tier 1 Risk-Based Capital | 4%       | \$ 200,095               | 38.71% |

**As of December 31, 2010**

(Dollars in thousands)

|                           | Required | Territorial Savings Bank |        |
|---------------------------|----------|--------------------------|--------|
| Tier 1 Capital            | 4%       | \$ 202,527               | 14.02% |
| Total Risk-Based Capital  | 8%       | \$ 204,015               | 43.06% |
| Tier 1 Risk-Based Capital | 4%       | \$ 202,527               | 42.75% |

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

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

**Contractual Obligations.** In the ordinary course of our operations, we enter into certain contractual obligations. Such obligations include operating leases for premises and equipment, agreements with respect to borrowed funds and deposit liabilities and agreements with respect to investments. Except for obtaining \$10.0 million of Federal Home Loan Bank advances, \$15.0 million of securities sold under agreements to repurchase and an increase of \$12.5 million in certificates of deposit between December 31, 2010 and September 30, 2011, there have not been any material changes in contractual obligations and funding needs since December 31, 2010.

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**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 previously required the computation of net portfolio value or NPV which is the difference between the present value of an institution's assets and liabilities. The Office of Thrift Supervision provided all institutions that filed a Consolidated Maturity/Rate Schedule as a part of their quarterly Thrift Financial Report with a report that measured the sensitivity of net portfolio value within a range of assumed changes in market interest rates. The Office of Thrift Supervision simulation model used 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 provided us with the results of the interest rate sensitivity model using the Consolidated Maturity/Rate Schedule.

The table below presents, as of June 30, 2011, 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.

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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                              | \$ 167,948        | \$ (130,586)                         | (43.74)%                 | 11.55%   | (7.16)%   |
| +200                              | \$ 217,098        | \$ (81,436)                          | (27.28)%                 | 14.41%   | (4.30)%   |
| +100                              | \$ 263,530        | \$ (35,004)                          | (11.73)%                 | 16.93%   | (1.78)%   |
| 0                                 | \$ 298,534        |                                      |                          | 18.71%   |   |
| (100)                             | \$ 315,357        | \$ 16,823                            | 5.64 %                   | 19.52%   | 0.80 %  |

- (1) Assumes an instantaneous uniform change in interest rates for 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 June 30, 2011, in the event of a 200 basis point increase in interest rates, we would experience a 27.28% decrease in net portfolio value. In the event of a 100 basis point decrease in interest rates, we would experience a 5.64% increase 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 utilize 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 2009, 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 as of June 30, 2011 that would result from the designated instantaneous changes in the interest rate yield curve:

| 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                              | \$ 230,549        | \$ (62,584)                          | (21.35)%                 | 15.21%   | (3.24)%   |
| +200                              | \$ 257,742        | \$ (35,391)                          | (12.07)%                 | 16.67%   | (1.78)%   |
| +100                              | \$ 282,420        | \$ (10,713)                          | (3.65)%                  | 17.94%   | (0.51)%   |
| 0                                 | \$ 293,133        |                                      |                          | 18.45%   |   |
| (100)                             | \$ 265,116        | \$ (28,017)                          | (9.56)%                  | 16.95%   | (1.50)%   |

- (1) Assumes an instantaneous uniform change in interest rates for 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 Office of the Comptroller of the Currency is now our primary federal regulator. Starting with the three months ended September 30, 2011, we will not receive NPV calculations from the Comptroller of the Currency but will rely instead on our own internal model.

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We believe that our interest rate risk position has not weakened between June 30, 2011 and September 30, 2011.

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 requires making certain assumptions that may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the net portfolio value tables presented assume that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and 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 interest income and will differ from actual results.

**ITEM 4. CONTROLS AND PROCEDURES**

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and 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 September 30, 2011. 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 September 30, 2011, 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.

**Table of Contents****PART II****ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

There have been no material changes from Risk Factors as previously disclosed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission for the period ended December 31, 2010.

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

(a) Not applicable.

(b) Not applicable.

(c) *Stock Repurchases*. The following table sets forth information in connection with repurchases of our shares of common stock during the third quarter of 2011:

| Period                                       | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs (1) (2) |
|--|----------------------------------|------------------------------|--|--|
| July 1, 2011 through July 31, 2011           | 13,097                           | \$ 20.83                     | 13,097   | 80,356   |
| August 1, 2011 through August 31, 2011       | 103,803                          | 20.20                        | 80,356   |  |
| September 1, 2011 through September 30, 2011 | 500,743                          | 19.20                        | 500,743  | 80,522   |
| Total  | 617,643                          | \$ 19.40                     | 594,196  | 80,522   |

- (1) On September 22, 2010, our Board of Directors authorized the repurchase of up to 733,988 shares of our common stock. In accordance with this authorization, we repurchased 733,988 shares of our common stock as of September 30, 2011.
- (2) On August 26, 2011, our Board of Directors authorized the repurchase of up to 581,265 shares of our common stock. In accordance with this authorization, we had repurchased 500,743 shares of our common stock as of September 30, 2011. This repurchase authorization expires on August 15, 2012.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. [RESERVED]**



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**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

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

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**SIGNATURES**

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

**TERRITORIAL BANCORP INC.**  
(Registrant)

Date: November 8, 2011

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

Date: November 8, 2011

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

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INDEX TO EXHIBITS

| Exhibit<br>Number | Description  |
|-------------------|--|
| 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.   |
| 101               | The following financial statements from Territorial Bancorp Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, filed on November 8, 2011, formatted in XBRL: (i) Consolidated Statements of Income, (ii) Condensed Consolidated Balance Sheets, (iii) Condensed Consolidated Statements of Cash Flows, (iv) Consolidated Statements of Equity, (v) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text. |
| 101.INS           | Interactive datafile                      XBRL Instance Document   |
| 101.SCH           | Interactive datafile                      XBRL Taxonomy Extension Schema Document  |
| 101.CAL           | Interactive datafile                      XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF           | Interactive datafile                      XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB           | Interactive datafile                      XBRL Taxonomy Extension Label Linkbase   |
| 101.PRE           | Interactive datafile                      XBRL Taxonomy Extension Presentation Linkbase Document   |