

Territorial Bancorp Inc.  
Form 10-Q  
November 08, 2013  
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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, 2013**

**or**

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

**For transition period from                      to**

**Commission File Number 1-34403**

**TERRITORIAL BANCORP INC.**

(Exact Name of Registrant as Specified in Charter)

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

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

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

**96813**  
(Zip Code)

**(808) 946-1400**

Registrant's telephone number, including area code

**Not Applicable**

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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   
Non-accelerated filer

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.

10,180,383 shares of Common Stock, par value \$0.01 per share, were issued and outstanding as of October 31, 2013.



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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, 2013	December 31, 2012
<b>ASSETS</b>		
Cash and cash equivalents	\$ 55,965	\$ 182,818
Investment securities held to maturity, at amortized cost (fair value of \$605,857 and \$584,125 at September 30, 2013 and December 31, 2012, respectively)	607,435	554,673
Federal Home Loan Bank stock, at cost	11,798	12,128
Loans held for sale	681	2,220
Loans receivable, net	827,946	774,876
Accrued interest receivable	4,382	4,367
Premises and equipment, net	5,141	5,056
Real estate owned	143	
Bank-owned life insurance	39,951	31,177
Deferred income taxes receivable	4,619	3,580
Investment receivable	1,096	
Prepaid expenses and other assets	2,353	3,732
<b>Total assets</b>	<b>\$ 1,561,510</b>	<b>\$ 1,574,627</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Liabilities:		
Deposits	\$ 1,258,358	\$ 1,237,847
Advances from the Federal Home Loan Bank	15,000	20,000
Securities sold under agreements to repurchase	47,000	70,000
Accounts payable and accrued expenses	25,272	23,017
Current income taxes payable	908	1,152
Advance payments by borrowers for taxes and insurance	2,383	3,639
<b>Total liabilities</b>	<b>1,348,921</b>	<b>1,355,655</b>
Stockholders Equity:		
Preferred stock, \$.01 par value; authorized 50,000,000 shares, no shares issued or outstanding		
Common stock, \$.01 par value; authorized 100,000,000 shares; issued and outstanding 10,180,383 and 10,806,248 shares at September 30, 2013 and December 31, 2012, respectively	102	108
Additional paid-in capital	79,531	93,616
Unearned ESOP shares	(7,462)	(7,829)

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Retained earnings	144,647	137,410
Accumulated other comprehensive loss	(4,229)	(4,333)
Total stockholders' equity	212,589	218,972
Total liabilities and stockholders' equity	\$ 1,561,510	\$ 1,574,627

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		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
<b>Interest and dividend income:</b>				
Investment securities	\$ 4,775	\$ 5,551	\$ 13,847	\$ 18,360
Loans	9,267	9,187	27,696	27,326
Dividends on FHLB stock	3		3	
Other investments	46	88	210	259
Total interest and dividend income	14,091	14,826	41,756	45,945
<b>Interest expense:</b>				
Deposits	1,031	1,492	3,225	4,644
Advances from the Federal Home Loan Bank	67	105	235	313
Securities sold under agreements to repurchase	422	629	1,370	2,364
Total interest expense	1,520	2,226	4,830	7,321
Net interest income	12,571	12,600	36,926	38,624
Provision for loan losses	45	167	47	172
Net interest income after provision for loan losses	12,526	12,433	36,879	38,452
<b>Noninterest income:</b>				
Service fees on loan and deposit accounts	598	444	1,667	1,474
Income on bank-owned life insurance	295	239	774	706
Gain on sale of investment securities	922	429	2,834	729
Gain on sale of loans	365	669	1,390	1,516
Other	143	141	329	346
Total noninterest income	2,323	1,922	6,994	4,771
<b>Noninterest expense:</b>				
Salaries and employee benefits	5,318	5,202	15,682	15,416
Occupancy	1,387	1,316	3,971	3,930
Equipment	853	800	2,576	2,423
Federal deposit insurance premiums	193	192	574	574
Loss on extinguishment of debt		123		321
Other general and administrative expenses	969	964	3,228	3,069
Total noninterest expense	8,720	8,597	26,031	25,733
Income before income taxes	6,129	5,758	17,842	17,490
Income taxes	2,298	2,111	6,709	6,457
Net income	\$ 3,831	\$ 3,647	\$ 11,133	\$ 11,033
<b>Basic earnings per share</b>				
Basic earnings per share	\$ 0.40	\$ 0.36	\$ 1.13	\$ 1.09
<b>Diluted earnings per share</b>				
Diluted earnings per share	\$ 0.39	\$ 0.36	\$ 1.12	\$ 1.08
<b>Cash dividends declared per common share</b>				
Cash dividends declared per common share	\$ 0.13	\$ 0.11	\$ 0.38	\$ 0.32
<b>Basic weighted-average shares outstanding</b>				
Basic weighted-average shares outstanding	9,676,304	10,052,630	9,810,725	10,126,371
<b>Diluted weighted-average shares outstanding</b>				
Diluted weighted-average shares outstanding	9,809,987	10,199,400	9,930,438	10,205,408

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See accompanying notes to consolidated financial statements.

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**TERRITORIAL BANCORP INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income (Unaudited)**  
**(Dollars in thousands)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net income	\$ 3,831	\$ 3,647	\$ 11,133	\$ 11,033
Change in unrealized loss on securities	3	8	21	18
Noncredit related gains on securities not expected to be sold	14	177	83	177
Other comprehensive income	17	185	104	195
Comprehensive income	\$ 3,848	\$ 3,832	\$ 11,237	\$ 11,228

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 Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive (Loss)/Income	Total Stockholders Equity
Balances at December 31, 2011	\$ 110	\$ 97,640	\$ (8,319)	\$ 128,300	\$ (3,770)	\$ 213,961
Net income				11,033		11,033
Other comprehensive income					195	195
Cash dividends declared				(3,418)		(3,418)
Share-based compensation	1	2,016				2,017
Allocation of 36,699 ESOP shares		438	367			805
Repurchase of 275,186 shares of company common stock	(2)	(5,890)				(5,892)
Exercise of 41,275 options on common stock		716				716
Balances at September 30, 2012	\$ 109	\$ 94,920	\$ (7,952)	\$ 135,915	\$ (3,575)	\$ 219,417
Balances at December 31, 2012	\$ 108	\$ 93,616	\$ (7,829)	\$ 137,410	\$ (4,333)	\$ 218,972
Net income				11,133		11,133
Other comprehensive income					104	104
Cash dividends declared				(3,896)		(3,896)
Share-based compensation	1	2,001				2,002
Allocation of 36,699 ESOP shares		478	367			845
Repurchase of 739,197 shares of company common stock	(7)	(16,564)				(16,571)
Balances at September 30, 2013	\$ 102	\$ 79,531	\$ (7,462)	\$ 144,647	\$ (4,229)	\$ 212,589

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 September 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 11,133	\$ 11,033
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	47	172
Depreciation and amortization	837	852
Deferred income tax benefit	(1,108)	(516)
Amortization of fees, discounts, and premiums	395	53
Origination of loans held for sale	(67,252)	(75,184)
Proceeds from sales of loans held for sale	70,181	75,899
Gain on sale of loans, net	(1,390)	(1,516)
Net gain on sale of real estate owned		(43)
Gain on sale of investment securities held to maturity	(2,834)	(729)
ESOP expense	845	805
Share-based compensation expense	2,002	2,016
Excess tax benefits from share-based compensation		(54)
(Increase) decrease in accrued interest receivable	(15)	104
Net increase in bank-owned life insurance	(774)	(706)
Net (increase) decrease in prepaid expenses and other assets	1,379	(186)
Net increase in accounts payable and accrued expenses	2,255	342
Net decrease in income taxes payable	(244)	(2,967)
Net cash provided by operating activities	15,457	9,375
<b>Cash flows from investing activities:</b>		
Purchases of investment securities held to maturity	(240,496)	(111,467)
Principal repayments on investment securities held to maturity	146,301	160,668
Proceeds from sale of investment securities held to maturity	42,034	9,983
Loan originations, net of principal repayments on loans receivable	(52,345)	(57,911)
Proceeds from redemption of Federal Home Loan Bank stock	330	110
Purchases of bank-owned life insurance	(8,000)	
Proceeds from sale of real estate owned		451
Purchases of premises and equipment	(922)	(484)
Net cash provided by (used in) investing activities	(113,098)	1,350

*(Continued)*

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

	Nine Months Ended September 30,	
	2013	2012
<b>Cash flows from financing activities:</b>		
Net increase in deposits	\$ 20,511	\$ 60,411
Proceeds from advances from the Federal Home Loan Bank	5,000	100
Repayments of advances from the Federal Home Loan Bank	(10,000)	(100)
Repayments of securities sold under agreements to repurchase	(23,000)	(38,300)
Purchases of Fed Funds		10
Sales of Fed Funds		(10)
Net decrease in advance payments by borrowers for taxes and insurance	(1,256)	(969)
Excess tax benefits from share-based compensation		54
Proceeds from issuance of common stock		717
Repurchases of company stock	(16,571)	(5,892)
Cash dividends paid	(3,896)	(3,418)
Net cash provided by (used in) financing activities	(29,212)	12,603
Net increase (decrease) in cash and cash equivalents	(126,853)	23,328
Cash and cash equivalents at beginning of the period	182,818	131,937
Cash and cash equivalents at end of the period	\$ 55,965	\$ 155,265
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for:		
Interest on deposits and borrowings	\$ 4,861	\$ 7,478
Income taxes	8,061	9,940
<b>Supplemental disclosure of noncash investing activities:</b>		
Loans transferred to real estate owned	\$ 143	\$ 176
Investments purchased, not settled	1,096	1,136

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, 2012. 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 the 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**

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In June 2011, the Financial Accounting Standards Board (FASB) amended the Comprehensive Income topic of the FASB Accounting Standards Codification (ASC). The amendment eliminated the option of presenting components of other comprehensive income as part of the statement of changes in stockholders' equity. Nonowner changes in stockholders' equity must be presented either in a continuous statement of comprehensive income or in two separate but consecutive statements. The amendment was effective for interim or annual periods beginning after December 15, 2011, with early

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adoption permitted. In December 2011, the FASB deferred the effective date of the part of this amendment requiring reclassifications out of accumulated other comprehensive income to be shown on the face of the financial statements to allow time for further deliberation. Until final reporting requirements were effective, previous disclosure requirements would remain in effect. The Company adopted this amendment on January 1, 2012, and other than the location of disclosures related to other comprehensive income, the adoption did not have a material effect on its consolidated financial statements. In February 2013, the FASB finalized the reporting requirements for reclassifications out of accumulated other comprehensive income. When an amount reclassified out of accumulated other comprehensive income is required to be reported in net income in its entirety, the effect on income statement items must be disclosed. When an amount reclassified out of accumulated other comprehensive income is not required to be reported in net income in its entirety in the same period, cross references to other required disclosures providing information about the transaction are required. This amendment was effective for reporting periods beginning after December 15, 2012. The Company adopted this amendment on January 1, 2013 and the adoption did not have a material effect on its consolidated financial statements.

In December 2011, the FASB amended the Balance Sheet topic of the FASB ASC. The amendment requires disclosures about the gross and net information related to instruments and transactions eligible for offset in the statement of financial position. The disclosures are meant to assist users of financial statements to more easily compare information that is presented based on the differing offsetting requirements of U.S. generally accepted accounting principles and International Financial Reporting Standards. In January 2013, the FASB issued a clarification that stated the amendment applies only to certain derivatives, repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset or subject to an enforceable master netting arrangement or similar agreement. The amendment was effective for interim and annual periods beginning on or after January 1, 2013. The Company adopted this amendment on January 1, 2013 and the adoption did not have a material effect on its consolidated financial statements.

**(4) Cash and Cash Equivalents**

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

(Dollars in thousands)	September 30, 2013	December 31, 2012
Cash and due from banks	\$ 9,636	\$ 10,574
Interest-earning deposits in other banks	46,329	172,244
Cash and cash equivalents	\$ 55,965	\$ 182,818

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

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(5) **Investment Securities**

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

(Dollars in thousands)	Carrying value		Gains		Gross unrealized Losses		Estimated fair value
<b>September 30, 2013:</b>							
Held to maturity:							
U.S. government-sponsored mortgage-backed securities	\$ 606,876	\$	13,038	\$	(14,616)	\$	605,298
Trust preferred securities	559						559
<b>Total</b>	<b>\$ 607,435</b>	<b>\$</b>	<b>13,038</b>	<b>\$</b>	<b>(14,616)</b>	<b>\$</b>	<b>605,857</b>
<b>December 31, 2012:</b>							
Held to maturity:							
U.S. government-sponsored mortgage-backed securities	\$ 554,252	\$	29,706	\$	(254)	\$	583,704
Trust preferred securities	421						421
<b>Total</b>	<b>\$ 554,673</b>	<b>\$</b>	<b>29,706</b>	<b>\$</b>	<b>(254)</b>	<b>\$</b>	<b>584,125</b>

The carrying and estimated fair value of investment securities at September 30, 2013 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)	Carrying value		Estimated fair value
Held to maturity:			
Due within 5 years	\$ 1,195	\$	1,203
Due after 5 years through 10 years	427		458
Due after 10 years	605,813		604,196
<b>Total</b>	<b>\$ 607,435</b>	<b>\$</b>	<b>605,857</b>

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

(Dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Proceeds from sales	\$ 13,943	\$ 5,424	\$ 43,131	\$ 9,983
Gross gains	922	429	2,834	729
Gross losses				



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During the three months ended September 30, 2013 and 2012, all sales were related to \$13.0 million and \$5.0 million, respectively, of held-to-maturity debt securities. During the nine months ended September 30, 2013 and 2012, all sales were related to \$40.3 million and \$9.3 million, respectively, of held-to-maturity debt securities. The sale of these securities, for which the Company had already collected a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio.

Investment securities with carrying values of \$247.3 million and \$221.3 million at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase and transaction clearing accounts.

Provided below is a summary of investment securities which were in an unrealized loss position at September 30, 2013 and December 31, 2012. The Company does not intend to sell these securities until such time as the value recovers or the securities mature and it is not more likely than not that the Company will be required to sell the securities prior to recovery of value or the securities mature.

Description of securities (Dollars in thousands)	Less than 12 months		12 months or longer		Number of securities	Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses		Fair value	Unrealized losses
September 30, 2013:							
Mortgage-backed securities	\$ 273,380	\$ 14,417	\$ 3,785	\$ 199	48	\$ 277,165	\$ 14,616
December 31, 2012:							
Mortgage-backed securities	\$ 32,921	\$ 253	\$ 47	\$ 1	21	\$ 32,968	\$ 254

**Mortgage-Backed Securities.** The unrealized losses on the Company's investment in mortgage-backed securities were caused by increases in market interest rates. All of the mortgage-backed securities are guaranteed by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. Since the decline in market value is attributable to changes in interest rates and not credit quality, and the Company does not intend to sell these investments until maturity and it is not more likely than not that the Company will be required to sell such investments prior to recovery of its amortized cost basis, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2013 and December 31, 2012.

**Trust Preferred Securities.** At September 30, 2013, the Company owns two trust preferred securities, PreTSL XXIII and XXIV. 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. Both 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 only three transactions have occurred over the past 21 months in the same tranche of securities owned by the Company. The 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.



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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, 2013.

PreTSL XXIV has a book value of \$0. PreTSL XXIII has a book value of \$559,000. The difference between the book value of \$559,000 and the remaining amortized cost basis of \$1.1 million is reported as other comprehensive loss and is related to noncredit factors such as the trust preferred securities market being inactive.

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 remaining amortized cost basis of \$1.1 million on its trust preferred securities could be credit-related 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)	2013		2012	
Balance at January 1,	\$	5,885	\$	5,885
Credit losses on debt securities for which other-than-temporary impairment was not previously recognized				
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)	2013		September 30, 2012	
Noncredit losses on other-than-temporarily impaired securities, net of taxes	\$	362	\$	502

Table of Contents**(6) Loans Receivable and Allowance for Loan Losses**

The components of loans receivable are as follows:

(Dollars in thousands)	September 30, 2013	December 31, 2012
Real estate loans:		
First mortgages:		
One- to four-family residential	\$ 795,739	\$ 741,334
Multi-family residential	4,918	6,888
Construction, commercial, and other	13,626	13,819
Home equity loans and lines of credit	15,493	15,202
Total real estate loans	829,776	777,243
Other loans:		
Loans on deposit accounts	351	493
Consumer and other loans	4,425	3,988
Total other loans	4,776	4,481
Less:		
Net unearned fees and discounts	(4,939)	(5,176)
Allowance for loan losses	(1,667)	(1,672)
	(6,606)	(6,848)
Loans receivable, net	\$ 827,946	\$ 774,876

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

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Balance, beginning of period	\$ 1,622	\$ 1,457	\$ 1,672	\$ 1,541
Provision for loan losses	45	167	47	172
	1,667	1,624	1,719	1,713
Charge-offs	(68)	(137)	(205)	(273)
Recoveries	68	8	153	55
Net charge-offs		(129)	(52)	(218)
Balance, end of period	\$ 1,667	\$ 1,495	\$ 1,667	\$ 1,495

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

(Dollars in thousands)	Residential Mortgage	Construction, Commercial and Other Mortgage Loans	Home Equity Loans and Lines of Credit	Consumer and Other	Unallocated	Totals
Three months ended						
September 30, 2013:						
Balance, beginning of period	\$ 513	\$ 813	\$ 35	\$ 125	\$ 136	\$ 1,622
Provision (reversal of allowance) for loan losses	(16)	14	(1)	44	4	45
	497	827	34	169	140	1,667
Charge-offs	(13)			(55)		(68)
Recoveries	49	11	1	7		68
Net charge-offs	36	11	1	(48)		
Balance, end of period	\$ 533	\$ 838	\$ 35	\$ 121	\$ 140	\$ 1,667
Nine months ended September 30, 2013:						
Balance, beginning of period	\$ 590	\$ 818	\$ 35	\$ 107	\$ 122	\$ 1,672
Provision (reversal of allowance) for loan losses	(84)	9	(7)	111	18	47
	506	827	28	218	140	1,719
Charge-offs	(94)			(111)		(205)
Recoveries	121	11	7	14		153
Net charge-offs	27	11	7	(97)		(52)
Balance, end of period	\$ 533	\$ 838	\$ 35	\$ 121	\$ 140	\$ 1,667

(Dollars in thousands)	Residential Mortgage	Construction, Commercial and Other Mortgage Loans	Home Equity Loans and Lines of Credit	Consumer and Other	Unallocated	Totals
Three months ended						
September 30, 2012:						
Balance, beginning of period	\$ 552	\$ 641	\$ 35	\$ 107	\$ 122	\$ 1,457
Provision for loan losses	157		2	8		167
	709	641	37	115	122	1,624
Charge-offs	(125)		(2)	(10)		(137)
Recoveries	6			2		8
Net charge-offs	(119)		(2)	(8)		(129)
Balance, end of period	\$ 590	\$ 641	\$ 35	\$ 107	\$ 122	\$ 1,495
Nine months ended September 30, 2012:						
Balance, beginning of period	\$ 631	\$ 285	\$ 258	\$ 291	\$ 76	\$ 1,541
Provision (reversal of allowance) for loan losses	151	364	(222)	(167)	46	172
	782	649	36	124	122	1,713
Charge-offs	(233)	(8)	(3)	(29)		(273)
Recoveries	41		2	12		55
Net charge-offs	(192)	(8)	(1)	(17)		(218)
Balance, end of period	\$ 590	\$ 641	\$ 35	\$ 107	\$ 122	\$ 1,495



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In 2012, the Company enhanced its methodology for reviewing its loan portfolio when calculating the allowance for loan losses. The modification consisted of additional segmentation of the residential mortgage loan portfolio by items such as year of origination, loan-to-value ratios, owner or nonowner occupancy status and the purpose of the loan (purchase, cash-out refinance, no cash-out refinance or construction). The allowance for loan loss for each segment of the loan portfolio is determined by calculating the historical loss of each segment for a two- to three-year look-back period and adding a qualitative adjustment for the following factors:

- Changes in lending policies and procedures;
- Changes in economic trends;
- Changes in types of loans in the loan portfolio;
- Changes in experience and ability of personnel in the loan origination and loan servicing departments;
- Changes in the number and amount of delinquent loans and classified assets;
- Changes in our internal loan review system;
- Changes in the value of underlying collateral for collateral dependent loans;
- Changes in any concentrations of credit; and
- External factors such as competition, legal and regulatory requirements on the level of estimated credit losses in the existing loan portfolio.

The Company also revised the qualitative factors that were used to determine the allowance for loan losses on construction, commercial and other mortgage loans, home equity loans and lines of credit and consumer and other loans. As a result of these modifications, the Company increased the portion of the allowance for loan losses attributable to construction, commercial and other mortgage loans and decreased the portion of the allowance for loan losses attributable to residential mortgages. The allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. The unallocated allowance is established for probable losses that have been incurred as of the reporting date but are not reflected in the allocated allowance.

Management considers the allowance for loan losses at September 30, 2013 to be at an appropriate level to provide for probable losses that can be reasonably estimated based on general and specific conditions. While the Company uses the best information it has available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. To the extent actual outcomes differ from the estimates, additional provisions for credit losses may be required that would reduce future earnings. In addition, as an integral part of their examination process, the Office of the Comptroller of the Currency will periodically review the allowance for loan losses. The Office of the Comptroller of the Currency may require the Company to increase the allowance based on their analysis of information available at the time of their examination.

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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 Mortgage	Construction, Commercial and Other Mortgage Loans	Home Equity Loans and Lines of Credit	Consumer and Other	Unallocated	Total
September 30, 2013:						
Allowance for loan losses:						
Ending allowance balance:						
Individually evaluated for impairment	\$	\$	\$	\$	\$	\$
Collectively evaluated for impairment	533	838	35	121	140	1,667
Total ending allowance balance	\$ 533	\$ 838	\$ 35	\$ 121	\$ 140	\$ 1,667
Loans:						
Ending loan balance:						
Individually evaluated for impairment	\$ 7,425	\$	\$ 162	\$	\$	\$ 7,587
Collectively evaluated for impairment	788,309	13,602	15,339	4,776		822,026
Total ending loan balance	\$ 795,734	\$ 13,602	\$ 15,501	\$ 4,776	\$	\$ 829,613
December 31, 2012:						
Allowance for loan losses:						
Ending allowance balance:						
Individually evaluated for impairment	\$	\$	\$	\$	\$	\$
Collectively evaluated for impairment	590	818	35	107	122	1,672
Total ending allowance balance	\$ 590	\$ 818	\$ 35	\$ 107	\$ 122	\$ 1,672
Loans:						
Ending loan balance:						
Individually evaluated for impairment	\$ 6,775	\$	\$ 160	\$	\$	\$ 6,935
Collectively evaluated for impairment	736,297	13,784	15,051	4,481		769,613
Total ending loan balance	\$ 743,072	\$ 13,784	\$ 15,211	\$ 4,481	\$	\$ 776,548

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

(Dollars in thousands)

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	September 30, 2013	December 31, 2012
Loans with no allocated allowance for loan losses	\$ 7,587	\$ 6,935
Loans with allocated allowance for loan losses		
Total impaired loans	\$ 7,587	\$ 6,935
Amount of allocated loan loss allowance	\$	\$

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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 Investment	Unpaid Principal Balance
September 30, 2013:		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 7,425	\$ 7,721
Home equity loans and lines of credit	162	165
<b>Total</b>	<b>\$ 7,587</b>	<b>\$ 7,886</b>
December 31, 2012:		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 6,775	\$ 7,175
Home equity loans and lines of credit	160	165
<b>Total</b>	<b>\$ 6,935</b>	<b>\$ 7,340</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 September 30,		For the Nine Months Ended September 30,	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
2013:				
With no related allowance recorded:				
One- to four-family residential mortgages	\$ 7,440	\$ 33	\$ 7,477	\$ 98
Home equity loans and lines of credit	162		161	
<b>Total</b>	<b>\$ 7,602</b>	<b>\$ 33</b>	<b>\$ 7,638</b>	<b>\$ 98</b>
2012:				
With no related allowance recorded:				
One- to four-family residential mortgages	\$ 7,084	\$ 69	\$ 7,114	\$ 153
Home equity loans and lines of credit	159	2	158	5
<b>Total</b>	<b>\$ 7,243</b>	<b>\$ 71</b>	<b>\$ 7,272</b>	<b>\$ 158</b>

There were no loans individually evaluated for impairment with a related allowance for loan loss as of September 30, 2013 or December 31, 2012. Loans individually evaluated for impairment do not have an allocated allowance for loan loss because they are written down to fair value.

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

(Dollars in thousands)	30 Days Past Due	59 Days Past Due	60 Days Past Due	89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Loans Not Past Due	Total Loans	Nonaccrual Loans	Loans More Than 90 Days Past Due and Still Accruing					
September 30, 2013:															
One- to four-family residential mortgages	\$	1,296	\$		\$	1,230	\$	2,526	\$	788,317	\$	790,843	\$	5,160	\$
Multi-family residential mortgages							4,891	4,891							
Construction, commercial and other mortgages							13,602	13,602							
Home equity loans and lines of credit							15,501	15,501	162						
Loans on deposit accounts							351	351							
Consumer and other		13		1		14	4,411	4,425							
<b>Total</b>	<b>\$</b>	<b>1,309</b>	<b>\$</b>	<b>1</b>	<b>\$</b>	<b>1,230</b>	<b>\$</b>	<b>2,540</b>	<b>\$</b>	<b>827,073</b>	<b>\$</b>	<b>829,613</b>	<b>\$</b>	<b>5,322</b>	<b>\$</b>
December 31, 2012:															
One- to four-family residential mortgages	\$	2,298	\$	152	\$	2,044	\$	4,494	\$	731,730	\$	736,224	\$	4,246	\$
Multi-family residential mortgages							6,848	6,848							
Construction, commercial and other mortgages							13,784	13,784							
Home equity loans and lines of credit		44				44	15,167	15,211	160						
Loans on deposit accounts							493	493							
Consumer and other		78		2		80	3,908	3,988							
<b>Total</b>	<b>\$</b>	<b>2,420</b>	<b>\$</b>	<b>154</b>	<b>\$</b>	<b>2,044</b>	<b>\$</b>	<b>4,618</b>	<b>\$</b>	<b>771,930</b>	<b>\$</b>	<b>776,548</b>	<b>\$</b>	<b>4,406</b>	<b>\$</b>

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

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The Company had 18 nonaccrual loans with a book value of \$5.3 million at September 30, 2013 and 19 nonaccrual loans with a book value of \$4.4 million as of December 31, 2012. The Company collected interest on nonaccrual loans of \$137,000 during the nine months ended September 30, 2013, but due to regulatory requirements, we recorded it as a reduction of principal. The Company collected or

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recognized interest income on nonaccrual loans of \$75,000 during the nine months ended September 30, 2012. The Company would have recognized additional interest income of \$200,000 and \$119,000 during the nine months ended September 30, 2013 and 2012, respectively, had the loans been accruing interest. The Company did not have any loans more than 90 days past due and still accruing interest as of September 30, 2013 or December 31, 2012.

The table below presents information related to loans modified in a troubled debt restructuring during the three and nine months ended September 30, 2013 and 2012:

(Dollars in thousands)	Number of Loans	2013 Pre- Modification Recorded Investment	Post- Modification Recorded Investment	Number of Loans	2012 Pre- Modification Recorded Investment	Post- Modification Recorded Investment
<b>Three months ended September 30:</b>						
One- to four-family residential		\$	\$	12	\$ 3,694	\$ 3,694
<b>Total</b>		<b>\$</b>	<b>\$</b>	<b>12</b>	<b>\$ 3,694</b>	<b>\$ 3,694</b>
<b>Nine months ended September 30:</b>						
One- to four-family residential	1	\$ 700	\$ 700	12	\$ 3,694	\$ 3,694
<b>Total</b>	<b>1</b>	<b>\$ 700</b>	<b>\$ 700</b>	<b>12</b>	<b>\$ 3,694</b>	<b>\$ 3,694</b>

There were no new troubled debt restructurings within the past 12 months that subsequently defaulted.

The Company had 20 troubled debt restructurings totaling \$5.7 million as of September 30, 2013 that were considered to be impaired. This total included 19 one- to four-family residential mortgage loans totaling \$5.5 million and one home equity loan for \$162,000. Seven of the loans, totaling \$2.3 million, are performing in accordance with their restructured terms and accruing interest at September 30, 2013. 12 of the loans, totaling \$3.1 million, are performing in accordance with their restructured terms but not accruing interest at September 30, 2013. One of the loans, for \$329,000, is more than 150 days delinquent and not accruing interest as of September 30, 2013. There were 20 troubled debt restructurings totaling \$5.2 million as of December 31, 2012 that were considered to be impaired. This total included 19 one- to four-family residential mortgage loans totaling \$5.1 million and one home equity loan for \$160,000. Eight of the loans, totaling \$2.5 million, are performing in accordance with their restructured terms and accruing interest at December 31, 2012. 11 of the loans, totaling \$2.4 million, are performing in accordance with their restructured terms but not accruing interest at December 31, 2012. One of the loans, for \$329,000, is more than 150 days delinquent and not accruing interest at December 31, 2012. 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.

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, 2013 and 2012, the Company sold \$69.2 million and \$75.1 million, respectively, of mortgage loans held for sale and recognized gains of \$1.4 million and \$1.5 million, respectively. During the three months ended September 30, 2013 and 2012, the Company sold \$22.1 million and \$28.9 million, respectively, of mortgage loans held for sale and recognized gains of \$365,000 and

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\$669,000, respectively. The Company had three loans held for sale totaling \$681,000 at September 30, 2013 and six loans held for sale totaling \$2.2 million at December 31, 2012.

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The Company serviced loans for others of \$71.6 million at September 30, 2013 and \$84.8 million at December 31, 2012. Of these amounts, \$3.3 million and \$5.1 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at September 30, 2013 and December 31, 2012, respectively. The amount of contractually specified servicing fees earned for the nine-month periods ended September 30, 2013 and 2012 was \$164,000 and \$212,000, respectively. The amount of contractually specified servicing fees earned for the three-month periods ended September 30, 2013 and 2012 was \$51,000 and \$68,000, respectively. The fees are reported as 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, 2013		December 31, 2012	
	Repurchase liability	Weighted average rate	Repurchase liability	Weighted average rate
Maturing:				
1 year or less			\$ 23,000	4.40%
Over 1 year to 2 years	\$ 47,000	2.11%		
Over 2 years to 3 years			47,000	2.11
Total	\$ 47,000	2.11%	\$ 70,000	2.86%

During the three months ended September 30, 2012, the Company prepaid \$10.0 million of securities sold under agreements to repurchase and incurred \$123,000 of prepayment penalties. During the nine months ended September 30, 2012, the Company prepaid \$25.0 million of securities sold under agreements to repurchase and incurred \$321,000 of prepayment penalties.

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, 2013. 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 Securities and the securities pledged are issued and guaranteed by U.S. government-sponsored enterprises.

(Dollars in thousands)	Carrying value of securities	Fair value of securities	Repurchase liability	Amount at risk	Weighted average months to maturity
Maturing:					
Over 90 days	\$ 54,831	\$ 54,358	\$ 47,000	\$ 7,831	17

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**(8) Offsetting of Financial Liabilities**

Securities sold under agreements to repurchase are subject to a conditional right of offset in the event of default. See Footnote 7, Securities Sold Under Agreements to Repurchase, for additional information.

(Dollars in thousands)	Gross amount of recognized liabilities	Gross amount offset in the balance sheet	Net amount of liabilities presented in the balance sheet	Gross amount not offset in the balance sheet	Financial instruments	Cash collateral pledged	Net amount
September 30, 2013:							
Securities sold under agreements to repurchase	\$ 47,000	\$	\$ 47,000	\$ 47,000	\$	\$	\$
December 31, 2012:							
Securities sold under agreements to repurchase	\$ 70,000	\$	\$ 70,000	\$ 70,000	\$	\$	\$

**(9) 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 for the SERP were as follows:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net periodic benefit cost for the period				
Service cost	\$ 41	\$ 49	\$ 124	\$ 147
Interest cost	28	25	83	74
Expected return on plan assets				
Amortization of prior service cost				
Recognized actuarial loss				
Recognized curtailment loss				
Net periodic benefit cost	\$ 69	\$ 74	\$ 207	\$ 221



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**(10) Employee Stock Ownership Plan**

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

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

Shares purchased by the ESOP are held by a trustee in an unallocated suspense account, and shares are released annually from the suspense account on a pro-rata basis as principal and interest payments are made by the ESOP to the Company. The trustee allocates the shares released among participants on the basis of each participant's proportional share of compensation relative to all participants. As shares are committed to be released from the suspense account, Territorial Savings Bank reports compensation expense based on the average fair value of shares released with a corresponding credit to stockholders' equity. The shares committed to be released are considered outstanding for earnings per share computations. Compensation expense recognized for the three months ended September 30, 2013 and 2012 amounted to \$249,000 and \$271,000, respectively. Compensation expense recognized for the nine months ended September 30, 2013 and 2012 amounted to \$772,000 and \$759,000, respectively.

Shares held by the ESOP trust were as follows:

	September 30, 2013	December 31, 2012
Allocated shares	227,291	191,577
Unearned shares	746,222	782,921
Total ESOP shares	973,513	974,498
Fair value of unearned shares, in thousands	\$ 16,394	\$ 17,890

The ESOP restoration plan is a nonqualified plan that provides supplemental benefits to certain executives who are prevented from receiving the full benefits contemplated by the 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, 2013 and 2012, we accrued \$63,000 and \$80,000, respectively, for the ESOP restoration plan. For the nine months ended September 30, 2013 and 2012, we accrued \$183,000 and \$185,000, respectively, for the ESOP restoration plan.

**(11) Share-Based Compensation**

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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

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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 five- to six-year vesting period during which participants are required to provide services in exchange for the awards.

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

(In thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
Compensation expense	\$ 675	\$ 693	\$ 2,002	\$ 2,016
Income tax benefit	314	368	966	1,091

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

### *Stock Options*

The table below presents the stock option activity for the nine months ended September 30, 2013 and 2012:

	Options	Weighted average exercise price	Remaining contractual life (years)	Aggregate intrinsic value (in thousands)
Options outstanding at December 31, 2012	832,954	\$ 17.38	7.67	\$ 4,554
Granted				
Exercised				
Forfeited				
Expired				
Options outstanding at September 30, 2013	832,954	\$ 17.38	6.92	\$ 3,821
Options outstanding at December 31, 2011	871,144	\$ 17.36	8.67	\$ 2,082
Granted	3,085	23.62	8.00	
Exercised	41,275	17.36		
Forfeited				
Expired				
Options outstanding at September 30, 2012	832,954	\$ 17.38	7.92	\$ 4,640
Options vested and exercisable at September 30, 2013	416,169	\$ 17.38	6.93	\$ 1,911



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The following summarizes certain stock option activity of the Company:

(In thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
Intrinsic value of stock options exercised	\$	\$	117	\$ 171
Cash received from stock options exercised			489	717
Tax benefits realized from stock options exercised			47	69
Total fair value of stock options that vested		3,052	3,188	3,052 3,188

As of September 30, 2013, the Company had \$2.2 million of unrecognized compensation costs related to the stock option plan. The cost of the stock option plan is being amortized over the five- to six-year vesting period. The fair value of the Company's stock options was determined using the Black-Scholes option pricing formula. The following assumptions were used in the formula for options issued in 2012 and 2010:

	2012	2010
Expected volatility	35.82%	31.98%
Risk-free interest rate	1.27%	2.58%
Expected dividends	1.86%	1.61%
Expected life (in years)	6.50	6.75
Grant price for the stock options	\$ 23.62	\$ 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 five- or 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 at the time of grant.

There were no options granted in 2011 or the nine months ended September 30, 2013.

### **Restricted Stock Awards**

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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.

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The table below presents the restricted stock award activity:

	Restricted stock awards	Weighted average grant date fair value
Nonvested at December 31, 2012	453,397	\$ 17.39
Granted		
Vested	113,332	17.39
Forfeited		
Nonvested at September 30, 2013	340,065	\$ 17.39
Nonvested at December 31, 2011	563,994	\$ 17.36
Granted	2,735	23.62
Vested	113,332	17.39
Forfeited		
Nonvested at September 30, 2012	453,397	\$ 17.39

As of September 30, 2013, the Company had \$5.8 million of unrecognized compensation costs related to restricted stock awards. The cost of the restricted stock awards is being amortized over the five- or six-year vesting period.

**(12) Earnings Per Share**

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

(Dollars in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$ 3,831	\$ 3,647	\$ 11,133	\$ 11,033
Weighted-average number of shares used in:				
Basic earnings per share	9,676,304	10,052,630	9,810,725	10,126,371
Dilutive common stock equivalents:				
Stock options and restricted stock units	133,683	146,770	119,713	79,037
Diluted earnings per share	9,809,987	10,199,400	9,930,438	10,205,408
Net income per common share, basic	\$ 0.40	\$ 0.36	\$ 1.13	\$ 1.09
Net income per common share, diluted	\$ 0.39	\$ 0.36	\$ 1.12	\$ 1.08

Table of Contents**(13) Other Comprehensive Loss**

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

(Dollars in thousands)	Unfunded pension liability	Noncredit related losses on securities not expected to be sold	Unrealized loss on securities	Total
<b>Three months ended September 30, 2013:</b>				
Balances at beginning of period	\$ 3,792	\$ 376	\$ 78	\$ 4,246
Other comprehensive income before reclassifications		(14)	(3)	(17)
Amounts reclassified from accumulated other comprehensive loss				
Net current period other comprehensive income		(14)	(3)	(17)
Balances at end of period	\$ 3,792	\$ 362	\$ 75	\$ 4,229
<b>Three months ended September 30, 2012:</b>				
Balances at beginning of period	\$ 2,966	\$ 679	\$ 115	\$ 3,760
Other comprehensive income before reclassifications		(177)	(8)	(185)
Amounts reclassified from accumulated other comprehensive loss				
Net current period other comprehensive income		(177)	(8)	(185)
Balances at end of period	\$ 2,966	\$ 502	\$ 107	\$ 3,575
<b>Nine months ended September 30, 2013:</b>				
Balances at beginning of period	\$ 3,792	\$ 445	\$ 96	\$ 4,333
Other comprehensive income before reclassifications		(83)	(21)	(104)
Amounts reclassified from accumulated other comprehensive loss				
Net current period other comprehensive income		(83)	(21)	(104)
Balances at end of period	\$ 3,792	\$ 362	\$ 75	\$ 4,229
<b>Nine months ended September 30, 2012:</b>				
Balances at beginning of period	\$ 2,966	\$ 679	\$ 125	\$ 3,770
Other comprehensive income before reclassifications		(177)	(18)	(195)
Amounts reclassified from accumulated other comprehensive loss				
Net current period other comprehensive income		(177)	(18)	(195)
Balances at end of period	\$ 2,966	\$ 502	\$ 107	\$ 3,575

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

(Dollars in thousands)	2013				2012			
	Pretax amount	Tax	After tax amount	Pretax amount	Tax	After tax amount		
<b>Three months ended</b>								
<b>September 30:</b>								
Unfunded pension liability	\$	\$	\$	\$	\$	\$		
Noncredit related losses on securities not expected to be sold	(23)	9	(14)	(294)	117	(177)		
Unrealized loss on securities	(5)	2	(3)	(15)	7	(8)		
<b>Total</b>	<b>\$ (28)</b>	<b>\$ 11</b>	<b>\$ (17)</b>	<b>\$ (309)</b>	<b>\$ 124</b>	<b>\$ (185)</b>		
<b>Nine months ended</b>								
<b>September 30:</b>								
Unfunded pension liability	\$	\$	\$	\$	\$	\$		
Noncredit related losses on securities not expected to be sold	(138)	55	(83)	(294)	117	(177)		
Unrealized loss on securities	(35)	14	(21)	(31)	13	(18)		
<b>Total</b>	<b>\$ (173)</b>	<b>\$ 69</b>	<b>\$ (104)</b>	<b>\$ (325)</b>	<b>\$ 130</b>	<b>\$ (195)</b>		

### **(14) 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 used to determine fair value as follows:

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

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

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

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

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

The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. The trust preferred securities market is considered to be inactive since there have been only three 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 using a discounted cash flow model. Our model used a discount rate equal to three-month LIBOR plus 20.00% and provided a fair value estimate of \$15.77 per \$100 of par value for PreTSL XXIII.

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

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

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

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

**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.

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*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.

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

(Dollars in thousands)	Carrying Amount	Fair Value	Fair Value Measurements Using		
			Level 1	Level 2	Level 3
<b>September 30, 2013</b>					
<b>Assets</b>					
Cash and cash equivalents	\$ 55,965	\$ 55,965	\$ 55,965	\$	\$
Investment securities held to maturity	607,435	605,857		605,298	559
FHLB stock	11,798	11,798	11,798		
Loans held for sale	681	714		714	
Loans receivable, net	827,946	857,894			857,894
Accrued interest receivable	4,382	4,382	4,382		
Interest rate contracts	130	130		130	
<b>Liabilities</b>					
Deposits	1,258,358	1,259,195	1,054,939		204,256
Advances from the Federal Home Loan Bank	15,000	15,175			15,175
Securities sold under agreements to repurchase	47,000	48,186			48,186
Accounts payable and accrued expenses (excluding interest rate contracts)	25,157	25,157	25,157		
Interest rate contracts	115	115		115	
Current income taxes payable	908	908	908		
Advance payments by borrowers for taxes and insurance	2,383	2,383	2,383		
<b>December 31, 2012</b>					
<b>Assets</b>					
Cash and cash equivalents	\$ 182,818	\$ 182,818	\$ 182,818	\$	\$
Investment securities held to maturity	554,673	584,125		583,704	421
FHLB stock	12,128	12,128	12,128		
Loans held for sale	2,220	2,335		2,335	
Loans receivable, net	774,876	831,734			831,734
Accrued interest receivable	4,367	4,367	4,367		
Interest rate contracts	124	124		124	
<b>Liabilities</b>					
Deposits	1,237,847	1,239,385	1,032,467		206,918
Advances from the Federal Home Loan Bank	20,000	20,397			20,397
Securities sold under agreements to repurchase	70,000	72,340			72,340
Accounts payable and accrued expenses (excluding interest rate contracts)	22,906	22,906	22,906		
Interest rate contracts	111	111		111	
Current income taxes payable	1,152	1,152	1,152		
Advance payments by borrowers for taxes and insurance	3,639	3,639	3,639		

At September 30, 2013 and December 31, 2012, 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.



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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, 2013:</b>					
Interest rate contracts	assets	\$	\$	130	\$ 130
Interest rate contracts	liabilities		(115)		(115)
<b>December 31, 2012:</b>					
Interest rate contracts	assets	\$	\$	124	\$ 124
Interest rate contracts	liabilities		(111)		(111)

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 table below presents the balance of assets measured at fair value on a nonrecurring basis as of September 30, 2013 and December 31, 2012 and the related losses for the nine months ended September 30, 2013 and the year ended December 31, 2012:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total	Total Gains/ (Losses)
<b>September 30, 2013:</b>					
Impaired loans	\$	\$	\$ 4,796	\$ 4,796	\$ 94
Trust preferred securities			559	559	138
<b>December 31, 2012:</b>					
Impaired loans	\$	\$ 468	\$ 4,907	\$ 5,375	\$ (222)
Mortgage servicing assets			651	651	(220)
Trust preferred securities			421	421	389

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

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

(Dollars in thousands)	Fair Value	Valuation Technique	Unobservable Input	Value
<b>September 30, 2013:</b>				
Impaired loans non-collateral dependent	\$ 4,796	Discounted cash flow	Discount rate (1)	3.15% - 6.94%
Trust preferred securities	559	Discounted cash flow	Discount rate	Three-month LIBOR plus 20%
<b>December 31, 2012:</b>				
Impaired loans non-collateral dependent	\$ 4,907	Discounted cash flow	Discount rate (1)	3.73% - 6.94%
Mortgage servicing assets	651	Discounted cash flow	Discount rate	10.00%
			Prepayment speed (PSA)	144.6 - 316.4
			Cost to service (Basis points)	40
Trust preferred securities	421	Discounted cash flow	Discount rate	Three-month LIBOR plus 20%

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

### (15) Subsequent Events

On October 31, 2013, the Board of Directors of Territorial Bancorp Inc. declared a quarterly cash dividend of \$0.14 per share of common stock. The dividend is expected to be paid on November 27, 2013 to stockholders of record as of November 14, 2013.

On October 31, 2013, the Board of Directors of Territorial Savings Bank approved an application to convert from a federal savings bank to a Hawaii-chartered savings bank. As part of the charter conversion, the Bank intends to file an application with the Federal Reserve Bank of San Francisco ( Federal Reserve ) to become a member bank. The holding company will continue to be regulated by the Federal Reserve and expects to remain a savings and loan holding company. The charter conversion remains subject to regulatory approvals, and no timetable has been established for the completion of the charter conversion.

## 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.

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

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

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

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- 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, 2012.

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**Comparison of Financial Condition at September 30, 2013 and December 31, 2012**

**Assets.** At September 30, 2013, our assets were \$1.562 billion, a decrease of \$13.1 million, or 0.8%, from \$1.575 billion at December 31, 2012. The decrease in assets was primarily the result of a decrease in cash and cash equivalents, which was partially offset by increases in loans receivable and investment securities.

**Cash and Cash Equivalents.** Cash and cash equivalents were \$56.0 million at September 30, 2013, a decrease of \$126.9 million since December 31, 2012. During the nine months ended September 30, 2013, cash was used to fund a \$51.5 million increase in total loans and a \$52.8 million increase in investment securities, and to pay off \$5.0 million of FHLB advances and \$23.0 million of securities sold under agreements to repurchase. In addition, the Company repurchased \$16.6 million of common stock and paid \$3.9 million of common stock dividends. This activity was partially offset by a \$20.5 million increase in deposits.

**Loans.** Total loans, including \$681,000 of loans held for sale, were \$828.6 million at September 30, 2013, or 53.1% of total assets. During the nine months ended September 30, 2013, the loan portfolio increased by \$51.5 million, or 6.6%. The increase in the loan portfolio occurred as the production of new one- to four-family residential loans exceeded principal repayments and loan sales. The continued high level of loan originations is due primarily to the current interest rate environment.

**Securities.** At September 30, 2013, our securities portfolio totaled \$607.4 million, or 38.9% of total assets. At September 30, 2013, all of such securities were classified as held-to-maturity and none of the underlying collateral consisted of subprime or Alt-A (traditionally defined as nonconforming loans having less than full documentation) loans. During the nine months ended September 30, 2013, our securities portfolio increased by \$52.8 million, or 9.5%, as purchases exceeded repayments and sales.

At September 30, 2013, we owned trust preferred securities with a carrying value of \$559,000. This portfolio consists of two securities, which represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions.

The trust preferred securities market is considered to be inactive as only three transactions have occurred over the past 21 months in the same tranche of securities owned by the Company. The 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. We used a discount rate equal to three-month LIBOR plus 20.00% and calculated a fair value estimate of \$15.77 per \$100 of par value for PreTSL XXIII.

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, 2013.

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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 remaining amortized cost basis of \$1.1 million on its trust preferred securities could be credit-related other-than-temporarily impaired in the near term. The impairment could be material to the Company's consolidated statements of income.

**Deposits.** Deposits were \$1.258 billion at September 30, 2013, an increase of \$20.5 million, or 1.7%, since December 31, 2012. The growth in deposits occurred in savings and checking accounts.

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**Borrowings.** Our borrowings consist of advances from the Federal Home Loan Bank of Seattle and funds borrowed under securities sold under agreements to repurchase. During the nine months ended September 30, 2013, our borrowings decreased by \$28.0 million, or 31.1%, to \$62.0 million due to the net pay off of \$5.0 million of FHLB advances and \$23.0 million of securities sold under agreements to repurchase. We have not required any other borrowings to fund our operations. Instead, we have primarily funded our operations with the net proceeds from our stock offering, additional deposits, proceeds from loan and security sales and principal repayments on loans and mortgage-backed securities.

**Average Balances and Yields**

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

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	For the Three Months Ended September 30,					
	2013			2012		
	Average Outstanding Balance	Interest	Yield/ Rate (1) (Dollars in thousands)	Average Outstanding Balance	Interest	Yield/ Rate (1)
<b>Interest-earning assets:</b>						
Loans:						
Real estate loans:						
First mortgage:						
One- to four-family residential (2)	\$ 790,885	\$ 8,750	4.43%	\$ 703,000	\$ 8,629	4.91%
Multi-family residential	5,404	77	5.70	6,826	104	6.09
Construction, commercial and other	13,449	168	5.00	11,652	158	5.42
Home equity loans and lines of credit	15,133	200	5.29	15,207	222	5.84
Other loans	4,818	72	5.98	4,791	74	6.18
Total loans	829,689	9,267	4.47	741,476	9,187	4.96
Investment securities:						
U.S. government sponsored mortgage-backed securities (2)	594,898	4,775	3.21	612,325	5,551	3.63
Trust preferred securities	535			35		
Total securities	595,433	4,775	3.21	612,360	5,551	3.63
Other	92,371	49	0.21	160,494	88	0.22
Total interest-earning assets	1,517,493	14,091	3.71	1,514,330	14,826	3.92
Non-interest-earning assets	62,052			48,105		
Total assets	\$ 1,579,545			\$ 1,562,435		
<b>Interest-bearing liabilities:</b>						
Savings accounts	\$ 890,488	\$ 722	0.32%	\$ 861,845	\$ 1,108	0.51%
Certificates of deposit	196,151	302	0.62	212,099	375	0.71
Money market accounts	835			532		
Checking and Super NOW accounts	132,251	7	0.02	115,715	9	0.03
Total interest-bearing deposits	1,219,725	1,031	0.34	1,190,191	1,492	0.50
Federal Home Loan Bank advances	15,000	67	1.79	19,998	105	2.10
Securities sold under agreements to repurchase	60,612	422	2.78	82,099	629	3.06
Total interest-bearing liabilities	1,295,337	1,520	0.47	1,292,288	2,226	0.69
Non-interest-bearing liabilities	65,285			51,540		
Total liabilities	1,360,622			1,343,828		
Stockholders equity	218,923			218,607		
Total liabilities and stockholders equity	\$ 1,579,545			\$ 1,562,435		
Net interest income		\$ 12,571			\$ 12,600	
Net interest rate spread (3)			3.24%			3.23%
Net interest-earning assets (4)	\$ 222,156			\$ 222,042		
Net interest margin (5)			3.31%			3.33%
Interest-earning assets to interest-bearing liabilities	117.15%			117.18%		

(1) Annualized

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

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

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	For the Nine Months Ended September 30,					
	2013			2012		
	Average Outstanding Balance	Interest	Yield/ Rate (1)	Average Outstanding Balance	Interest	Yield/ Rate (1)
	(Dollars in thousands)					
<b>Interest-earning assets:</b>						
Loans:						
Real estate loans:						
First mortgage:						
One- to four-family residential (2)	\$ 771,725	\$ 26,121	4.51%	\$ 682,826	\$ 25,575	4.99%
Multi-family residential	5,980	259	5.77	6,755	311	6.14
Construction, commercial and other	13,392	497	4.95	11,870	500	5.62
Home equity loans and lines of credit	14,985	606	5.39	16,062	707	5.87
Other loans	4,743	213	5.99	5,056	233	6.14
Total loans	810,825	27,696	4.55	722,569	27,326	5.04
Investment securities:						
U.S. government sponsored mortgage-backed securities (2)	569,196	13,847	3.24	632,208	18,360	3.87
Trust preferred securities	472			33		
Total securities	569,668	13,847	3.24	632,241	18,360	3.87
Other	132,549	213	0.21	158,197	259	0.22
Total interest-earning assets	1,513,042	41,756	3.68	1,513,007	45,945	4.05
Non-interest-earning assets	59,553			51,758		
Total assets	\$ 1,572,595			\$ 1,564,765		
<b>Interest-bearing liabilities:</b>						
Savings accounts	\$ 886,923	\$ 2,266	0.34%	\$ 842,717	\$ 3,354	0.53%
Certificates of deposit	194,742	937	0.64	217,268	1,262	0.77
Money market accounts	752	1	0.18	520	1	0.26
Checking and Super NOW accounts	127,407	21	0.02	113,634	27	0.03
Total interest-bearing deposits	1,209,824	3,225	0.36	1,174,139	4,644	0.53
Federal Home Loan Bank advances	16,117	235	1.94	20,000	313	2.09
Securities sold under agreements to repurchase	64,016	1,370	2.85	96,550	2,364	3.26
Total interest-bearing liabilities	1,289,957	4,830	0.50	1,290,689	7,321	0.76
Non-interest-bearing liabilities	63,034			56,029		
Total liabilities	1,352,991			1,346,718		
Stockholders equity	219,604			218,047		
Total liabilities and stockholders equity	\$ 1,572,595			\$ 1,564,765		
Net interest income		\$ 36,926			\$ 38,624	
Net interest rate spread (3)			3.18%			3.29%
Net interest-earning assets (4)	\$ 223,085			\$ 222,318		
Net interest margin (5)			3.25%			3.40%
Interest-earning assets to interest-bearing liabilities	117.29%			117.22%		

(1) Annualized

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

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

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**Comparison of Operating Results for the Three Months Ended September 30, 2013 and 2012**

**General.** Net income increased by \$184,000, or 5.0%, to \$3.8 million for the three months ended September 30, 2013 from \$3.6 million for the three months ended September 30, 2012. The increase in net income was primarily caused by a \$706,000 decrease in interest expense, a \$401,000 increase in noninterest income and a \$122,000 decrease in provision for loan losses. This was partially offset by a \$735,000 decrease in interest and dividend income, a \$123,000 increase in noninterest expense and a \$187,000 increase in income taxes.

**Net Interest Income.** Net interest income remained constant at \$12.6 million for the three months ended September 30, 2013 and 2012. Interest and dividend income decreased by \$735,000, or 5.0%, due primarily to a 21 basis point decrease in the average yield on interest-earning assets. Interest expense decreased by \$706,000, or 31.7%, due to a 22 basis point decrease in the average cost of interest-bearing liabilities. The interest rate spread and net interest margin were 3.24% and 3.31%, respectively, for the three months ended September 30, 2013, compared to 3.23% and 3.33%, respectively, for the three months ended September 30, 2012.

**Interest and Dividend Income.** Interest and dividend income decreased by \$735,000, or 5.0%, to \$14.1 million for the three months ended September 30, 2013 from \$14.8 million for the three months ended September 30, 2012. Interest income on investment securities decreased by \$776,000, or 14.0%, to \$4.8 million for the three months ended September 30, 2013 from \$5.6 million for the three months ended September 30, 2012. The decrease in interest income on securities occurred primarily because of a 42 basis point decrease in the average securities yield and a \$16.9 million decrease in the average securities balance. The decline in the average yield on investments occurred as repayments and sales of higher yielding mortgage-backed securities were reinvested at lower yields. Interest income on loans increased by \$80,000, or 0.9%, to \$9.3 million for the three months ended September 30, 2013 from \$9.2 million for the three months ended September 30, 2012. The increase in interest income on loans occurred because the average balance of loans grew by \$88.2 million, or 11.9%, as new loan originations exceeded loan repayments and loan sales. The increase in average balance was partially offset by a 49 basis point decline in the average loan yield to 4.47% for the three months ended September 30, 2013 compared to 4.96% for the three months ended September 30, 2012. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio.

**Interest Expense.** Interest expense decreased by \$706,000, or 31.7%, to \$1.5 million for the three months ended September 30, 2013 compared to \$2.2 million for the three months ended September 30, 2012. Interest expense on deposits decreased by \$461,000, or 30.9%, to \$1.0 million for the three months ended September 30, 2013 from \$1.5 million for the three months ended September 30, 2012. During the three months ended September 30, 2013, interest expense on savings accounts and certificates of deposit declined by \$386,000 and \$73,000, respectively, compared to the three months ended September 30, 2012. During the three months ended September 30, 2013, the average interest rates on savings accounts and certificates of deposit decreased by 19 and nine basis points, respectively, compared to the three months ended September 30, 2012. 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. However, the interest rates on our savings accounts are still higher than market interest rates in Hawaii. The decrease in the average interest rate on deposits was partially offset by a \$29.5 million, or 2.5%, increase in the average balance of deposit accounts. Interest expense on securities sold under agreements to repurchase decreased by \$207,000, or 32.9%, during the three months ended September 30, 2013 compared to the three months ended

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September 30, 2012. The decrease was caused by a \$21.5 million, or 26.2%, decrease in the average outstanding balance and a 28 basis point decrease in the average interest rate to 2.78% for the three months ended September 30, 2013 compared to 3.06% for the three months ended September 30, 2012. The decrease in the average outstanding balance was due to the payoff of \$23.0 million of borrowings since September 30, 2012. Interest expense on FHLB advances decreased by \$38,000, or 36.2%, during the three months ended September 30, 2013 compared to the three months ended September 30, 2012. The decrease was caused by a \$5.0 million, or 25.0%, decrease in the average outstanding balance and a 31 basis point decrease in the average interest rate to 1.79% for the three months ended September 30, 2013 compared to 2.10% for the three months ended September 30, 2012. The decrease in the average outstanding balance occurred when \$10.0 million of maturing advances were paid off and a new \$5.0 million advance was obtained during the nine months ended September 30, 2013.

**Provision for Loan Losses.** We recorded provisions for loan losses of \$45,000 and \$167,000 for the three months ended September 30, 2013 and 2012, respectively. The provisions for loan losses reflected net charge-offs of \$0 and \$129,000 for the three months ended September 30, 2013 and 2012, respectively. The provisions resulted in ratios of the allowance for loan losses to total loans of 0.20% at September 30, 2013 and 2012. Nonaccrual loans totaled \$5.3 million at September 30, 2013, or 0.64% of total loans at that date, compared to \$4.6 million of nonaccrual loans at September 30, 2012, or 0.62% of total loans at that date. Nonaccrual loans as of September 30, 2013 and 2012 consisted primarily of one- to four-family residential real estate loans. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2013 and 2012. For additional information see footnote (6), Loans Receivable and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

**Noninterest Income.** The following table summarizes changes in noninterest income between the three months ended September 30, 2013 and 2012.

	Three Months Ended		Change	
	September 30, 2013	September 30, 2012	\$ Change	% Change
	(In thousands)			
Service fees on loan and deposit accounts	\$ 598	\$ 444	\$ 154	34.7%
Income on bank-owned life insurance	295	239	56	23.4%
Gain on sale of investment securities	922	429	493	114.9%
Gain on sale of loans	365	669	(304)	(45.4)%
Other	143	141	2	1.4%
<b>Total</b>	<b>\$ 2,323</b>	<b>\$ 1,922</b>	<b>\$ 401</b>	<b>20.9%</b>

Noninterest income rose by \$401,000 for the three months ended September 30, 2013 compared to the three months ended September 30, 2012. During the three months ended September 30, 2013 and 2012, we sold \$13.0 million and \$5.0 million, respectively, of held-to-maturity investment securities and recognized gains of \$922,000 and \$429,000, respectively. The sale of these securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio. Service fees on loan and deposit accounts increased by \$154,000 during the three months ended September 30, 2013 compared to the three months ended September 30, 2012 primarily due to an increase in the amortization of mortgage servicing assets during the three months ended September 30, 2012. During the three months ended September 30, 2013 and 2012, we also sold \$22.1 million and \$28.9 million, respectively, of mortgage loans held for sale to reduce interest rate risk and recognized gains of \$365,000 and \$669,000, respectively.

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**Noninterest Expense.** The following table summarizes changes in noninterest expense between the three months ended September 30, 2013 and 2012.

	Three Months Ended		Change	
	September 30, 2013	2012	\$ Change	% Change
	(In thousands)			
Salaries and employee benefits	\$ 5,318	\$ 5,202	\$ 116	2.2%
Occupancy	1,387	1,316	71	5.4%
Equipment	853	800	53	6.6%
Federal deposit insurance premiums	193	192	1	0.5%
Loss on extinguishment of debt		123	(123)	(100.0)%
Other general and administrative expenses	969	964	5	0.5%
<b>Total</b>	<b>\$ 8,720</b>	<b>\$ 8,597</b>	<b>\$ 123</b>	<b>1.4%</b>

Noninterest expense rose by \$123,000 for the three months ended September 30, 2013 compared to the three months ended September 30, 2012. Salaries and employee benefits increased by \$116,000 to \$5.3 million for the three months ended September 30, 2013 from \$5.2 million for the three months ended September 30, 2012. The increase in salaries and employee benefits was primarily due to a bank-wide budgeted salary increase of approximately 2.0% that was effective July 1, 2012 and a \$72,000 decrease in the credit to compensation expense for the cost of originating new mortgage loans, which occurred because of a decline in new loan originations. This was partially offset by an \$83,000 decrease in loan agent compensation. The Receivables topic of the FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating loans. During the three months ended September 30, 2012, the Company prepaid \$10.0 million of securities sold under agreements to repurchase, which had a weighted-average interest rate of 2.78%, and incurred \$123,000 of prepayment penalties, which is reported as loss on extinguishment of debt.

**Income Tax Expense.** Income taxes were \$2.3 million and \$2.1 million for the three months ended September 30, 2013 and 2012, respectively, reflecting an effective tax rate of 37.5% and 36.7%, respectively. The effective tax rate for 2013 was higher than the tax rate in 2012 primarily due to a decrease in permanent tax benefits related to our share-based compensation plans.

### **Comparison of Operating Results for the Nine Months Ended September 30, 2013 and 2012**

**General.** Net income increased by \$100,000, or 0.9%, to \$11.1 million for the nine months ended September 30, 2013 from \$11.0 million for the nine months ended September 30, 2012. The increase in net income was caused by a \$2.5 million decrease in interest expense, a \$2.2 million increase in noninterest income and a \$125,000 decrease in the provision for loan losses. This was partially offset by a \$4.2 million decrease in interest and dividend income, a \$298,000 increase in noninterest expense and a \$252,000 increase in income taxes.

**Net Interest Income.** Net interest income decreased by \$1.7 million, or 4.4%, to \$36.9 million for the nine months ended September 30, 2013 compared to \$38.6 million for the nine months ended September 30, 2012. Interest and dividend income decreased by \$4.2 million, or 9.1%, due primarily to a 37 basis point decrease in the average yield. Interest expense decreased by \$2.5 million, or 34.0%, due to a 26 basis point decrease in the average cost of interest-bearing liabilities. The interest rate spread and net interest margin were 3.18% and 3.25%, respectively, for the nine months ended September 30, 2013, compared to 3.29% and 3.40%, respectively, for the nine months ended September 30, 2012.



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**Interest and Dividend Income.** Interest and dividend income decreased by \$4.2 million or 9.1%, to \$41.8 million for the nine months ended September 30, 2013 from \$45.9 million for the nine months ended September 30, 2012. Interest income on investment securities decreased by \$4.5 million, or 24.6%, to \$13.8 million for the nine months ended September 30, 2013 from \$18.4 million for the nine months ended September 30, 2012. The decrease in interest income on securities occurred because of a \$62.6 million decrease in the average securities balance and a 63 basis point decrease in the average securities yield. The decline in the average yield on investments occurred as repayments and sales of higher yielding mortgage-backed securities were reinvested at lower yields. Interest income on loans increased by \$370,000, or 1.4%, to \$27.7 million for the nine months ended September 30, 2013 from \$27.3 million for the nine months ended September 30, 2012. The increase in interest income on loans occurred because the average balance of loans grew by \$88.3 million, or 12.2%, as new loan originations exceeded loan repayments and loan sales. The increase in interest income that occurred because of growth in the loan portfolio was partially offset by a 49 basis point decline in the average loan yield to 4.6% for the nine months ended September 30, 2013. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio.

**Interest Expense.** Interest expense decreased by \$2.5 million, or 34.0%, to \$4.8 million for the nine months ended September 30, 2013 compared to \$7.3 million for the nine months ended September 30, 2012. Interest expense on deposits decreased by \$1.4 million, or 30.6%, to \$3.2 million for the nine months ended September 30, 2013 from \$4.6 million for the nine months ended September 30, 2012. During the nine months ended September 30, 2013, interest expense on savings accounts and certificates of deposit declined by \$1.1 million and \$325,000, respectively. During the nine months ended September 30, 2013, the average interest rates on savings accounts and certificates of deposit decreased by 19 and 13 basis points, respectively, compared to the nine months ended September 30, 2012. 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. However, the interest rates on our savings accounts are still higher than market interest rates in Hawaii. The decrease in the average interest rate on deposits was partially offset by a \$35.7 million, or 3.0%, increase in the average balance of deposit accounts. Interest expense on securities sold under agreements to repurchase decreased by \$994,000, or 42.0%, during the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012. The decrease was caused by a \$32.5 million, or 33.7%, decrease in the average outstanding balance and a 41 basis point decrease in the average interest rate to 2.9% for the nine months ended September 30, 2013 compared to 3.3% for the nine months ended September 30, 2012. The decrease in the average outstanding balance was due to the payoff of \$23.0 million of borrowings since September 30, 2012. Interest expense on FHLB advances decreased by \$78,000, or 24.9%, during the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012. The decrease was caused by a \$3.9 million, or 19.4%, decrease in the average outstanding balance and a 15 basis point decrease in the average interest rate to 1.9% for the nine months ended September 30, 2013 compared to 2.1% for the nine months ended September 30, 2012. The decrease in the average outstanding balance occurred when \$10.0 million of maturing advances were paid off and a new \$5.0 million advance was obtained during the nine months ended September 30, 2013.

**Provision for Loan Losses.** We recorded provisions for loan losses of \$47,000 and \$172,000 for the nine months ended September 30, 2013 and 2012, respectively. The provisions for loan losses reflected net charge-offs of \$52,000 and \$218,000 for the nine months ended September 30, 2013 and

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2012, respectively. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.20% at September 30, 2013 and 2012. Nonaccrual loans totaled \$5.3 million at September 30, 2013, or 0.64% of total loans at that date, compared to \$4.6 million of nonaccrual loans at September 30, 2012, or 0.62% of total loans at that date. Nonaccrual loans as of September 30, 2013 and 2012 consisted primarily of one- to four-family residential real estate loans. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2013 and 2012. For additional information see footnote (6), Loans Receivable and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

**Noninterest Income.** The following table summarizes changes in noninterest income between the nine months ended September 30, 2013 and 2012.

	Nine Months Ended		Change	
	September 30, 2013	September 30, 2012	\$ Change	% Change
	(In thousands)			
Service fees on loan and deposit accounts	\$ 1,667	\$ 1,474	\$ 193	13.1%
Income on bank-owned life insurance	774	706	68	9.6%
Gain on sale of investment securities	2,834	729	2,105	288.8%
Gain on sale of loans	1,390	1,516	(126)	(8.3)%
Other	329	346	(17)	(4.9)%
Total	\$ 6,994	\$ 4,771	\$ 2,223	46.6%

Noninterest income rose by \$2.2 million for the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012. During the nine months ended September 30, 2013 and 2012, we sold \$40.3 million and \$9.3 million, respectively, of held-to-maturity investment securities and recognized gains of \$2.8 million and \$729,000, respectively. The sale of these securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio. Service fees on loan and deposit accounts increased by \$193,000 during the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012 primarily due to an increase in the amortization of mortgage servicing assets during the nine months ended September 30, 2012. During the nine months ended September 30, 2013 and 2012, we also sold \$69.2 million and \$75.1 million, respectively, of mortgage loans held for sale to reduce interest rate risk and recognized gains of \$1.4 million and \$1.5 million, respectively.

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**Noninterest Expense.** The following table summarizes changes in noninterest expense between the nine months ended September 30, 2013 and 2012.

	Nine Months Ended		Change	
	September 30, 2013	2012	\$ Change	% Change
	(In thousands)			
Salaries and employee benefits	\$ 15,682	\$ 15,416	\$ 266	1.7%
Occupancy	3,971	3,930	41	1.0%
Equipment	2,576	2,423	153	6.3%
Federal deposit insurance premiums	574	574		%
Loss on extinguishment of debt		321	(321)	(100.0)%
Other general and administrative expenses	3,228	3,069	159	5.2%
<b>Total</b>	<b>\$ 26,031</b>	<b>\$ 25,733</b>	<b>\$ 298</b>	<b>1.2%</b>

Noninterest expense rose by \$298,000 for the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012. Salaries and employee benefits increased by \$266,000 to \$15.7 million for the nine months ended September 30, 2013 from \$15.4 million for the nine months ended September 30, 2012. The increase in salaries and employee benefits was primarily due to a bank-wide budgeted salary increase of approximately 2.0% that was effective July 1, 2012, and increases in health insurance and payroll taxes. This increase was partially offset by a \$109,000 increase in the credit to compensation expense for the cost of originating new mortgage loans because of an increase in new loan originations. The Receivables topic of the FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating loans. Equipment expense increased by \$153,000 primarily due to higher furniture, fixture and equipment, and data processing expenses. Other general and administrative expenses increased by \$159,000 to \$3.2 million for the nine months ended September 30, 2013 from \$3.1 million for the nine months ended September 30, 2012. The increase in other general and administrative expenses was primarily due to higher legal costs and a loss on a deposit account. The increases in expenses were partially offset by a \$321,000 decrease in loss on extinguishment of debt. During the nine months ended September 30, 2012, the Company prepaid \$25.0 million of securities sold under agreements to repurchase, which had a weighted-average interest rate of 4.07%, and incurred \$321,000 of prepayment penalties, which is reported as loss on extinguishment of debt.

**Income Tax Expense.** Income taxes were \$6.7 million for the nine months ended September 30, 2013, reflecting an effective tax rate of 37.6% compared to \$6.5 million for the nine months ended September 30, 2012, reflecting an effective tax rate of 36.9%. The increase in the effective tax rate is primarily attributed to a decrease in permanent tax benefits related to our share-based compensation plans.

### **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, securities sold under agreements to repurchase, proceeds from loan and security sales and principal repayments on securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We have established an Asset/Liability Management Committee, consisting of our President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Treasurer and our Vice President and Controller, which is responsible for establishing and monitoring



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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, 2013.

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 or securities and may also be used to pay off short-term borrowings.

Our most liquid asset is cash. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2013, cash and cash equivalents totaled \$56.0 million. On that date, we had \$47.0 million in securities sold under agreements to repurchase outstanding and \$15.0 million of Federal Home Loan Bank advances outstanding, with the ability to borrow an additional \$375.6 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, 2013, we had \$18.9 million in loan commitments outstanding, most of which were for fixed-rate loans, and had \$22.7 million in unused lines of credit to borrowers. Certificates of deposit due within one year at September 30, 2013 totaled \$143.5 million, or 11.4% of total deposits. If these deposits do not remain with us, we may be required to seek other sources of funds, including loan sales, brokered deposits, securities sold under agreements to repurchase and Federal Home Loan Bank advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before September 30, 2014. We believe, however, based on past experience that a significant portion of such deposits will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

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Our primary investing activities are originating loans and purchasing mortgage-backed securities. During the three months ended September 30, 2013 and 2012, we originated \$65.9 million and \$96.3 million of loans, respectively, and purchased \$73.3 million and \$45.2 million of securities, respectively. During the nine months ended September 30, 2013 and 2012, we originated \$240.5 million and \$263.8 million of loans, respectively, and purchased \$240.5 million and \$112.6 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 \$20.5 million and \$60.4 million for the nine months ended September 30, 2013 and 2012, 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.

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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. Federal Home Loan Bank advances decreased by \$5.0 million during the nine months ended September 30, 2013 and remained constant at \$20.0 million during the nine months ended September 30, 2012. We had the ability to borrow up to an additional \$375.6 million and \$371.5 million from the Federal Home Loan Bank of Seattle as of September 30, 2013 and 2012, respectively. We also utilize securities sold under agreements to repurchase as another borrowing source. Securities sold under agreements to repurchase decreased by \$23.0 million and \$38.3 million for the nine months ended September 30, 2013 and 2012, respectively.

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, 2013, 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, 2013 and December 31, 2012.

As of September 30, 2013  
(Dollars in thousands)

	Required	Territorial Savings Bank		
Tier 1 Capital	4%	\$	195,848	12.51%
Total Risk-Based Capital	8%	\$	197,540	32.29%
Tier 1 Risk-Based Capital	4%	\$	195,848	32.02%

As of December 31, 2012  
(Dollars in thousands)

	Required	Territorial Savings Bank		
Tier 1 Capital	4%	\$	207,295	13.13%
Total Risk-Based Capital	8%	\$	208,991	36.87%
Tier 1 Risk-Based Capital	4%	\$	207,295	36.57%

### **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 paying off \$23.0 million of securities sold under agreements to repurchase and \$5.0 million of FHLB advances and a decrease of \$2.0 million in certificates of deposit between December 31, 2012 and September 30, 2013, there have not been any material

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changes in contractual obligations and funding needs since December 31, 2012.

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

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

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

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

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

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The following table presents our internal calculations of the estimated changes in our EVE as of June 30, 2013 that would result from the designated instantaneous changes in the interest rate yield curve.

Change in Interest Rates (bp) (1)	Estimated EVE (2)	Estimated Increase (Decrease) in EVE (Dollars in thousands)	Percentage Change in EVE	EVE Ratio as a Percent of Present Value of Assets (3)(4)	Increase (Decrease) in EVE Ratio as a Percent of Present Value of Assets (3)(4)
+400	\$ 193,164	\$ (54,760)	(22.09)%	12.90%	(2.72)%
+300	\$ 209,778	\$ (38,146)	(15.39)%	13.81%	(1.81)%
+200	\$ 228,958	\$ (18,966)	(7.65)%	14.84%	(0.78)%
+100	\$ 247,369	\$ (555)	(0.22)%	15.79%	0.17%
0	\$ 247,924			15.62%	
(100)	\$ 257,249	\$ 9,325	3.76%	16.17%	0.55%

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

There was no significant change in mortgage interest rates between June 30, 2013 and September 30, 2013. We consequently do not believe that there has been a material change in our EVE during the third quarter.

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

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

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

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amended) as of September 30, 2013. 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, 2013, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

In addition to the other information contained in this Quarterly Report on Form 10-Q, the following risk factor represents material updates and additions to the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 as filed with the Securities and Exchange Commission. Additional risks not presently known to us, or that we currently deem immaterial, may also adversely affect our business, financial condition or results of operations. Further, to the extent that any of the information contained in this Quarterly Report on Form 10-Q constitutes forward-looking statements, the risk factor set forth below also is a cautionary statement identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

The recent federal government shutdown is expected to have a negative effect on Hawaii's economy during the fourth quarter of 2013. Any future federal government shutdown could negatively affect our financial condition and results of operations.

The recent federal government shutdown could result in reduced income for government employees or employees of companies that engage in business with the federal government, which could result in greater loan delinquencies, increases in our nonperforming, criticized and classified assets and a decline in demand for our products and services. Any future federal government shutdown could have the same negative effect. Hawaii's economy is dependent on federal government programs and on the visitor industry. A federal government shutdown could cause decreased expenditures for government programs and in the number of visitors to the state.

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

(a) Not applicable.

(b) Not applicable.

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(c) **Stock Repurchases.** The following table sets forth information in connection with repurchases of our shares of common stock during the third quarter of 2013:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (1)
July 1, 2013 through July 31, 2013		\$		383,064
August 1, 2013 through August 31, 2013	131,667	\$	22.18	107,552
September 1, 2013 through September 30, 2013	275,512	\$	21.76	275,512
Total	407,179	\$	21.90	383,064

(1) On June 6, 2013, our Board of Directors authorized the repurchase of up to 532,000 shares of our common stock. We completed the repurchase on September 30, 2013.

### ITEM 3.                    DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4.                    MINE SAFETY DISCLOSURES

Not applicable.

### ITEM 5.                    OTHER INFORMATION

None.

### ITEM 6.                    EXHIBITS

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



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**SIGNATURES**

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

**TERRITORIAL BANCORP INC.**  
(Registrant)

Date: November 8, 2013

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

Date: November 8, 2013

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

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**INDEX TO EXHIBITS**

<b>Exhibit Number</b>	<b>Description</b>
31.1	Certification of Allan S. Kitagawa, Chairman of the Board, President and Chief Executive Officer, Pursuant to Rule 13a-14(a) and Rule 15d-14(a).
31.2	Certification of Melvin M. Miyamoto, Senior Vice President and Treasurer, Pursuant to Rule 13a-14(a) and Rule 15d-14(a).
32	Certification of Allan S. Kitagawa, Chairman of the Board, President and Chief Executive Officer, and Melvin M. Miyamoto, Senior Vice President and Treasurer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial statements from Territorial Bancorp Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, filed on November 8, 2013, formatted in XBRL: (i) Consolidated Statements of Income, (ii) Consolidated Balance Sheets, (iii) Consolidated Statements of Cash Flows, (iv) Consolidated Statements of Stockholders Equity and Comprehensive Income, (v) Consolidated Statements of Comprehensive Income and (vi) the Notes to Consolidated Financial Statements.
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