

Territorial Bancorp Inc.  
Form 10-K  
March 14, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

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

**For the Fiscal Year Ended December 31, 2015**

**OR**

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

**For the transition period from            to**

**Commission File Number: 001-34403**

**Territorial Bancorp Inc.**

(Name of Registrant as Specified in its Charter)

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

**26-4674701**  
(I.R.S. Employer  
Identification Number)

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

**96813**  
(Zip Code)

**(808) 946-1400**

(Registrant's Telephone Number including area code)

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

**Common Stock, par value \$0.01 per share**

(Title of Class)

**The NASDAQ Stock Market LLC**

(Name of exchange on which registered)

Securities Registered Under Section 12(g) of the Exchange Act:

**None**

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports), and (2) has been subject to such 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

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

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

The aggregate value of the voting common equity held by nonaffiliates of the registrant, computed by reference to the closing price of the registrant's shares of common stock as of June 30, 2015 (\$24.26) was \$211.5 million.

As of February 29, 2016, there were 9,659,685 shares outstanding of the registrant's common stock.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2016 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

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**FORWARD-LOOKING STATEMENTS**

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

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

These forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. Except as may be required by law, we disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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, 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 or credit markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- our ability to enter new markets successfully and capitalize on growth opportunities;
- our ability to successfully integrate acquired entities, if any;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board;
- changes in our organization, compensation and benefit plans;

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- the timing and amount of revenues that we may recognize;
- the value and marketability of collateral underlying our loan portfolios;
- the impact of recent legislation to restructure the U.S. financial and regulatory system;
- the quality and composition of our investment portfolio;
- 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. Please also see Item 1A. Risk Factors.

**PART I**

**ITEM 1. Business**

**Territorial Bancorp Inc.**

Territorial Bancorp Inc. is a Maryland corporation and owns 100% of the outstanding common stock of Territorial Savings Bank. On July 10, 2009, we completed our initial public offering of common stock in connection with the mutual-to-stock conversion of Territorial Mutual Holding Company, selling 12,233,125 shares of common stock at \$10.00 per share. Since the completion of our initial public offering, we have not engaged in any significant business activity other than owning the common stock of and having savings deposits in Territorial Savings Bank, paying dividends and repurchasing shares of common stock. At December 31, 2015, we had consolidated assets of \$1.821 billion, consolidated deposits of \$1.445 billion and consolidated stockholders' equity of \$219.6 million.

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Our executive offices are located at 1132 Bishop Street, Suite 2200, Honolulu, Hawaii 96813. Our telephone number at this address is (808) 946-1400.

### **Territorial Savings Bank**

Territorial Savings Bank is a Hawaii state-chartered savings bank headquartered in Honolulu, Hawaii. Territorial Savings Bank was organized in 1921, and reorganized into the mutual holding company structure in 2002. Territorial Savings Bank is currently the wholly-owned subsidiary of Territorial Bancorp Inc. We provide financial services to individuals, families and businesses through our 28 banking offices located throughout the State of Hawaii.

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

Territorial Savings Bank's executive offices are located at 1132 Bishop Street, Suite 2200, Honolulu, Hawaii 96813. Our telephone number at this address is (808) 946-1400.



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### **Available Information**

Territorial Bancorp Inc. is a public company, and files interim, quarterly and annual reports with the Securities and Exchange Commission. These reports are on file and a matter of public record with the Securities and Exchange Commission and may be read and copied at the Securities and Exchange Commission's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC (<http://www.sec.gov>).

Our website address is [www.territorialsavings.net](http://www.territorialsavings.net). Information on our website should not be considered a part of this annual report.

### **General**

Territorial Savings Bank's business consists primarily of accepting deposits from the general public and investing those deposits, together with funds generated from operations and borrowings, in one- to four-family residential mortgage loans and investment securities. To a much lesser extent, we also originate home equity loans and lines of credit, construction, commercial and other nonresidential real estate loans, consumer loans, multi-family mortgage loans and other loans. Territorial Savings Bank offers a variety of deposit accounts, including passbook and statement savings accounts, certificates of deposit, money market accounts, commercial and regular checking accounts and Super NOW accounts. Through our subsidiary, Territorial Financial Services, Inc., we engage in insurance agency activities. We also offer various non-deposit investments to our customers, including annuities and mutual funds, through a third-party broker-dealer.

### **Market Area**

We conduct business from our corporate offices and from our 28 full-service branch offices located throughout the State of Hawaii.

The largest sector of Hawaii's economy is the visitor industry. The Hawaii Tourism Authority reported that 8.6 million visitors came to the state in 2015, a 4.1% increase compared to 2014. The increase in visitor arrivals is primarily due to growth in the number of visitors from the continental United States, Australia and China. Total visitor expenditures in 2015 totaled \$15.159 billion, a 2.3% increase compared to 2014.

The unemployment rate for the State of Hawaii was 3.2% in December 2015, representing a decrease from a 4.0% rate in December 2014. Hawaii's unemployment rate continued to be lower than the 5.0% rate for the entire United States for December 2015. The growth in the visitor and construction industries have supported the local economy and kept the state's unemployment rate lower than the national rate. The construction of several new condominium projects and work on the City and County of Honolulu's mass transit project has increased employment in Hawaii's construction industry.

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The number of sales and the median sale prices of existing single-family homes and condominium units sold increased in 2015 compared to 2014. On the island of Oahu, the primary real estate market in Hawaii, sales of existing single-family homes totaled 3,455 units for the year ended December 31, 2015, an increase of 5.2% compared to sales in 2014. The number of condominium sales, a notable portion of the overall housing market, grew by 4.5% in 2015 compared to 2014. The median price paid on Oahu for a single-family home in December 2015 was \$700,000, an increase of 1.4% compared to the median price in December 2014. The median price paid on Oahu for condominiums in December 2015 was \$386,250, an increase of 6.9% compared to the median price in December 2014.

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On the island of Maui, the second largest real estate market in Hawaii, sales of existing single-family homes totaled 1,090 units in 2015, an increase of 15.7% compared to similar sales during 2014. The number of condominium sales decreased by two units in 2015 compared to 2014. The median price paid for a single-family home on Maui in December 2015 was \$580,000, an increase of 1.8% compared to the median price in December 2014. The median price paid on Maui for condominiums in December 2015 was \$410,000, a 7.9% increase compared to the median price in December 2014.

Foreclosure and bankruptcy filings fell in 2015 compared to 2014. In 2015, there were 1,826 mortgage foreclosure cases in Hawaii, a 12.4% decrease from 2014. In 2015, there were 1,569 bankruptcy filings, a decrease of 7.8% compared to the number of filings in 2014. The decrease in foreclosure and bankruptcy filings is primarily due to growth in Hawaii's economy.

**Competition**

We face intense competition in our market area both in making loans and attracting deposits. We compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies and investment banking firms. Some of our competitors have greater name recognition and market presence that benefit them in attracting business, and offer certain services that we do not or cannot provide.

Our deposit sources are primarily concentrated in the communities surrounding our banking offices, located in all four counties in the State of Hawaii. As of June 30, 2015 (the latest date for which information is publicly available), we ranked fifth in FDIC-insured deposit market share in the State of Hawaii (out of 13 banks and thrift institutions with offices in Hawaii), with a 3.7% market share. As of that date, our largest market share was in the City and County of Honolulu, where we ranked fifth in deposit market share (out of 13 banks and thrift institutions with offices in the City and County) with a 3.9% market share.

**Lending Activities**

Our primary lending activity is the origination of one- to four-family residential mortgage loans. To a much lesser extent, we also originate home equity loans and lines of credit, construction, commercial and other nonresidential real estate loans, consumer loans, multi-family mortgage loans and commercial business loans.

***One- to Four-Family Residential Mortgage Loans.*** At December 31, 2015, \$1.146 billion, or 95.9% of our total loan portfolio, consisted of one- to four-family residential mortgage loans. We offer conforming, fixed-rate and adjustable-rate residential mortgage loans with maturities generally up to 30 years. There has been little demand for adjustable-rate mortgage loans in our market area.

One- to four-family residential mortgage loans are generally underwritten according to Fannie Mae and Freddie Mac guidelines, and we refer to loans that conform to such guidelines as conforming loans. We generally originate both fixed- and adjustable-rate mortgage loans in amounts up

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to the maximum conforming loan limits as established by the Federal Housing Finance Agency, which is currently \$625,500 for single-family homes located in the State of Hawaii. We also originate loans above this amount, which are referred to as jumbo loans. These jumbo loan amounts are generally up to \$1.0 million, although we do originate loans above this amount. We generally originate fixed-rate jumbo loans with terms of up to 30 years. We have not originated significant amounts of adjustable-rate jumbo loans in recent years due to customer preference for fixed-rate loans in our market area. We generally underwrite jumbo loans in a manner similar to conforming loans. Jumbo loans are not uncommon in our market area.

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We originate loans with loan-to-value ratios in excess of 80%, up to and including a loan-to-value ratio of 100%. We generally require private mortgage insurance for loans with loan-to-value ratios in excess of 80%. During the year ended December 31, 2015, we originated \$9.8 million of one- to four-family residential mortgage loans with loan-to-value ratios in excess of 80%. We offer a variety of credit programs for low- to moderate-income and first-time home purchasers. These include our first time home purchaser program, where the borrower will receive up to a 50 basis point reduction in points charged in connection with the loan. We also originate first mortgage loans to lower-income individuals who reside in rural census tracts where the U.S. Department of Agriculture will issue a second mortgage and complete the underwriting of the loan, subject to our review before origination. We also offer both FHA and VA fixed-rate loans.

Other than our loans for the construction of one- to four-family residential mortgage loans (described under *Nonresidential Real Estate Loans*), we currently do not originate new interest only mortgage loans on one- to four-family residential properties (where the borrower pays interest for an initial period, after which the loan converts to a fully amortizing loan). We also do not offer loans that provide for negative amortization of principal, such as Option ARM loans, where the borrower can pay less than the interest owed on their loan, resulting in an increased principal balance during the life of the loan. We do not offer subprime loans (loans that generally target borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios) or Alt-A loans (traditionally defined as nonconforming loans having less than full documentation).

***Home Equity Loans and Lines of Credit.*** In addition to traditional one- to four-family residential mortgage loans, we offer home equity loans and home equity lines of credit that are secured primarily by one- to four-family residential homes. Home equity lines of credit have a maximum term of 10 years during which time the borrower is required to make payments to principal based on the amortization of 0.125% of principal outstanding per month. The borrower is permitted to draw against the line during the entire term. Our home equity lines of credit are originated with adjustable rates of interest or with fixed rates of interest that convert to adjustable rates of interest after an initial period of up to three years. Our home equity loans are originated with fixed rates of interest and with terms of up to 30 years. Home equity loans and lines of credit are generally underwritten with the same criteria that we use to underwrite one- to four-family residential mortgage loans. Home equity loans may be underwritten with a loan-to-value ratio of 80% when combined with the principal balance of the existing mortgage loan, while lines of credit for owner-occupied properties and investment properties may be underwritten with loan-to-value ratios of 80% and 65%, respectively, when combined with the principal balance of the existing mortgage loan. We require appraisals on home equity loans and lines of credit. At the time we close a home equity loan or line of credit, we record a mortgage to perfect our security interest in the underlying collateral. At December 31, 2015, the outstanding balance of home equity loans totaled \$3.0 million, or 0.3% of our total loan portfolio, and the outstanding balance of home equity lines of credit totaled \$12.3 million, or 1.0% of our total loan portfolio.

***Nonresidential Real Estate Loans.*** Our nonresidential real estate loans consist primarily of commercial real estate loans and construction loans for residential real estate projects. These loans totaled \$19.3 million, or 1.6% of our loan portfolio as of December 31, 2015. The commercial real estate properties primarily include owner-occupied light industrial properties. We generally seek to originate commercial real estate loans with initial principal balances of \$1.0 million or less. Loans secured by



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commercial real estate totaled \$9.8 million, or 0.8%, of our total loan portfolio at December 31, 2015, and consisted of 12 loans outstanding with an average loan balance of approximately \$815,000. All of our nonresidential real estate loans are secured by properties located in our primary market area. At December 31, 2015, our largest commercial real estate loan had a principal balance of \$3.1 million and was secured by real property and improvements utilized as an office building. This loan was performing in accordance with its original terms at December 31, 2015.

In the underwriting of commercial real estate loans, we generally lend up to the lesser of 75% of the property's appraised value or purchase price. We base our decision to lend primarily on the economic viability of the property and the creditworthiness of the borrower. In evaluating a proposed commercial real estate loan, we emphasize the ratio of the property's projected net cash flow to the loan's debt service requirement (generally requiring a minimum ratio of 110%), computed after deduction for a vacancy factor and property expenses we deem appropriate. Personal guarantees are usually obtained from commercial real estate borrowers. We require title insurance, fire and extended coverage casualty insurance, and, if appropriate, flood insurance, in order to protect our security interest in the underlying property. Almost all of our commercial real estate loans are generated internally by our loan officers.

Commercial real estate loans generally carry higher interest rates and have shorter terms than one- to four-family residential mortgage loans. Commercial real estate loans, however, entail greater credit risks compared to one- to four-family residential mortgage loans, as they typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment of loans secured by income-producing properties typically depends, in large part, on sufficient income from the property to cover operating expenses and debt service. Changes in economic conditions that are not in the control of the borrower or lender could affect the value of the collateral for the loan or the future cash flow of the property. Additionally, any decline in real estate values may be more pronounced for commercial real estate than for residential properties.

We also originate a limited amount of construction loans to experienced developers, almost exclusively for the construction of residential real estate projects. Construction loans are also made to individuals for the construction of their personal residences. Construction loans to individuals are generally interest-only loans during the construction period, and convert to permanent, amortizing loans following the completion of construction. At December 31, 2015, construction loans totaled \$7.2 million, or 0.6% of total loans receivable. At December 31, 2015, the additional unadvanced portion of these construction loans totaled \$3.7 million.

Construction financing generally involves greater credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction cost is inaccurate, we may be required to advance additional funds beyond the amount originally committed in order to protect the value of the property. Moreover, if the estimated value of the completed project is inaccurate, the borrower may hold a property with a value that is insufficient to assure full repayment of the construction loan upon the sale of the property. In the event we make a land acquisition loan on property that is not yet approved for the planned development, there is the risk that approvals will not be granted or will be delayed. We currently do not have any land acquisition development and construction loans. Construction loans also expose us to the risk that improvements will not be completed on time in accordance with specifications and projected costs. In addition, the ultimate sale or rental of the property may not occur as anticipated.

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***Loan Originations, Purchases, Sales and Servicing.*** All loans that we originate are underwritten pursuant to our policies and procedures, which incorporate standard underwriting guidelines, including those of Freddie Mac and Fannie Mae, to the extent applicable. We originate both adjustable-rate and fixed-rate loans. However, in our market area, customer demand is primarily for fixed-rate loans. Our loan origination and sales activity may be adversely affected by a rising interest rate environment that typically results in decreased loan demand. Most of our one- to four-family residential mortgage loan originations are generated by our branch managers and employees located in our banking offices and our additional commissioned loan officers located in our corporate headquarters. We also advertise throughout our market area. We also receive loans from mortgage brokers, mortgage bankers and other financial institutions that work with our staff to process and close these loans. We underwrite and approve all of these loans.

We sell loans to assist us in managing interest rate risk. We sold \$56.2 million, \$37.5 million and \$82.2 million of residential mortgage loans (all fixed-rate loans, with terms of 10 years or longer) during the years ended December 31, 2015, 2014 and 2013, respectively. We had six loans totaling \$2.1 million classified as held for sale at December 31, 2015.

We sell our loans without recourse, except for normal representations and warranties provided in sales transactions. At December 31, 2015, we were servicing loans owned by others with a principal balance of \$51.8 million. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, contacting delinquent borrowers, supervising foreclosures and property dispositions in the event of unremedied defaults, making certain insurance and tax payments on behalf of the borrowers and generally administering the loans. We retain a portion of the interest paid by the borrower on the loans we service as consideration for our servicing activities. For the year ended December 31, 2015, we received servicing fees of \$153,000. At December 31, 2015, substantially all of the loans serviced for Freddie Mac and Fannie Mae were performing in accordance with their contractual terms and we believe that there are no material repurchase obligations associated with these loans.

***Loan Approval Procedures and Authority.*** Our lending activities follow written, nondiscriminatory underwriting standards and loan origination procedures established by our Board of Directors. The loan approval process is intended to assess the borrower's ability to repay the loan and value of the property that will secure the loan. To assess the borrower's ability to repay, we review the borrower's employment and credit history and information on the historical and projected income and expenses of the borrower.

Our policies and loan approval limits are established by the Board of Directors. Aggregate lending relationships in amounts up to \$5.0 million can be approved by designated individual officers or officers acting together with specific lending approval authority. Relationships in excess of \$5.0 million require the approval of the Loan Committee of the Board of Directors.

Territorial Savings Bank also uses automated systems to underwrite one- to four-family residential mortgage loans with balances up to \$625,500. We require appraisals of all real property securing one- to four-family residential real estate loans, and on property securing home equity loans and lines of credit. All appraisers are licensed appraisers and all third-party appraisers are approved by the Board of Directors annually.

**Investments**



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Our Board of Directors has primary responsibility for establishing and overseeing our investment policy. The Board of Directors has delegated authority to implement the investment policy to our Investment Committee, consisting of our President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Chief Financial Officer and our Vice President and Controller. The investment policy is reviewed at least annually by the Investment

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Committee, and any changes to the policy are subject to approval by the full Board of Directors. The overall objectives of the Investment Policy are to maintain a portfolio of high quality and diversified investments to maximize interest income over the long term and to minimize risk, to provide collateral for borrowings, to provide additional earnings when loan production is low, and to reduce our tax liability. The policy dictates that investment decisions give consideration to the safety of principal, liquidity requirements and potential returns. Our Senior Vice President and Chief Financial Officer executes our securities portfolio transactions as directed by the Investment Committee. All purchase and sale transactions are reported to the Board of Directors on a monthly basis.

Our current investment policy permits investments in securities issued by the United States Government as well as mortgage-backed securities and direct obligations of Fannie Mae, Freddie Mac and Ginnie Mae. The investment policy also permits, with certain limitations, investments in certificates of deposit, bank-owned life insurance, collateralized mortgage obligations, trust preferred securities, municipal securities and stock in the Federal Home Loan Bank and the Federal Reserve Bank. We purchased stock in the Federal Home Loan Bank in order to obtain services such as demand deposit accounts, certificates of deposit, security safekeeping services and borrowings in the form of advances. As a member of the Federal Reserve System, we are required to hold stock in the Federal Reserve Bank.

Our current 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. As of December 31, 2015, we held no asset-backed securities other than mortgage-backed securities. As a state savings bank, Territorial Savings Bank is not permitted to invest in equity securities. This general restriction does not apply to Territorial Bancorp Inc.

The Investments Debt and Equity Securities topic of the Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) requires that, at the time of purchase, we designate a security as either held-to-maturity, available-for-sale, or trading, based upon our ability and intent to hold the security until maturity. Securities in the available-for-sale and trading classifications are reported at market value and securities in the held-to-maturity classification are reported at amortized cost. A periodic review and evaluation of the available-for-sale and held-to-maturity securities portfolios is conducted to determine if the fair value of any security has declined below its carrying value and whether such decline is other-than-temporary. If we do not have the intent to sell a security and it is not more likely than not that we will be required to sell a security, impairment occurs when the present value of the remaining cash flows is less than the remaining amortized cost basis. The difference between the present value of remaining cash flows and the remaining amortized cost basis is considered a credit loss. If a credit loss has occurred, impairment is recorded by writing down the value of a security to its fair market value as a charge to earnings. The difference between the write down and the credit loss is considered other comprehensive loss, which is a reduction of stockholders' equity.

Our held-to-maturity securities at December 31, 2015 consisted primarily of securities with the following carrying values: \$481.5 million of mortgage-backed securities, \$10.7 million of collateralized mortgage obligations and \$916,000 of trust preferred securities that were issued by pools of issuers consisting primarily of financial institution holding companies. At December 31, 2015, all of our mortgage-backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac or Ginnie Mae. At December 31, 2015, there were no securities classified as available-for-sale. At December 31, 2015, none of the collateral underlying our securities portfolio was considered subprime or Alt-A, and we did not hold any common or preferred stock issued by Freddie Mac or Fannie Mae as of that date. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Balance Sheet Analysis Securities for a discussion of the recent performance of our securities portfolio. The fair values of our securities are usually based on published or securities dealers' market values.

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Mortgage-backed securities are securities issued in the secondary market that are collateralized by pools of mortgages. Certain types of mortgage-backed securities are commonly referred to as pass-through certificates because the principal and interest of the underlying loans is passed through to investors, net of certain costs, including servicing and guarantee fees. Mortgage-backed securities typically are collateralized by pools of one- to four-family or multi-family mortgages. We invest primarily in mortgage-backed securities backed by one- to four-family mortgages. The interest rate of the security is lower than the interest rates of the underlying loans to allow for payment of servicing and guaranty fees. Ginnie Mae, a United States Government agency, and government sponsored enterprises, such as Fannie Mae and Freddie Mac, either guarantee the payments or guarantee the timely payment of principal and interest to investors. Mortgage-backed securities are more liquid than individual mortgage loans since there is an active trading market for such securities. In addition, mortgage-backed securities may be used to collateralize our borrowings. Investments in mortgage-backed securities involve a risk that actual payments will be greater or less than the prepayment rate estimated at the time of purchase, which may require adjustments to the amortization of any premium or accretion of any discount relating to such interests, thereby affecting the net yield on our securities.

**Sources of Funds**

*General.* Deposits traditionally have been our primary source of funds for our investment and lending activities. We also borrow from the Federal Home Loan Bank and from securities dealers through securities sold under agreements to repurchase to supplement cash flow needs, to lengthen the maturities of liabilities for interest rate risk management purposes and to manage our cost of funds. Our additional sources of funds are loan repayments, maturing investments, retained earnings, income on other earning assets and the proceeds of loan and security sales.

*Deposits.* We accept deposits primarily from the areas in which our offices are located. We rely on our competitive pricing and products, convenient locations and quality customer service to attract and retain deposits. We offer a variety of deposit accounts with a range of interest rates and terms. Our deposit accounts consist of passbook and statement savings accounts, certificates of deposit, money market accounts, commercial and regular checking accounts and Super NOW accounts. Historically, we have not accepted brokered deposits.

Interest rates paid, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies, market interest rates, liquidity requirements and our deposit growth goals.

*Borrowings.* Our borrowings consist of advances from the Federal Home Loan Bank and funds borrowed from securities sold under agreements to repurchase. At December 31, 2015, our Federal Home Loan Bank advances totaled \$69.0 million, or 4.3% of total liabilities and securities sold under agreements to repurchase totaled \$55.0 million, or 3.4% of total liabilities. At December 31, 2015, we had access to additional Federal Home Loan Bank advances of up to \$555.1 million. Advances from the Federal Home Loan Bank are secured by our investment in the common stock of the Federal Home Loan Bank as well as by a blanket pledge on our assets not otherwise pledged. Securities sold under agreements to repurchase are secured by mortgage-backed securities.



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**Subsidiary Activities**

Territorial Savings Bank owns 100% of the common stock of Territorial Financial Services, Inc., a Hawaii corporation that engages primarily in insurance activities. At December 31, 2015, Territorial Savings Bank's investment in Territorial Financial Services, Inc. was \$12,000, and Territorial Financial Services, Inc. had assets of \$78,000 at that date. Territorial Savings Bank also owns 100% of the common stock of Territorial Real Estate Co., Inc., an inactive Hawaii corporation that is authorized to manage and dispose of problem real estate.

**Personnel**

As of December 31, 2015, we had 269 full-time employees and 11 part-time employees. Our employees are not represented by any collective bargaining group. Management believes that we have a good working relationship with our employees.

**FEDERAL AND STATE TAXATION**

**Federal Taxation**

*General.* Territorial Bancorp Inc. and Territorial Savings Bank are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize material federal income tax matters and is not a comprehensive description of the tax rules applicable to Territorial Bancorp Inc. and Territorial Savings Bank.

*Method of Accounting.* For federal income tax purposes, Territorial Bancorp Inc. currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31st for filing its consolidated federal income tax returns.

*Minimum Tax.* The Internal Revenue Code of 1986, as amended, imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, referred to as alternative minimum taxable income. The alternative minimum tax is payable to the extent alternative minimum taxable income is in excess of an exemption amount. Net operating losses can, in general, offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. At December 31, 2015 and 2014, Territorial Bancorp Inc. had no alternative minimum tax credit carryforward.

*Net Operating Loss Carryovers.* A financial institution may carry back net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. At December 31, 2015 and 2014, Territorial Savings Bank had no net operating loss carryforward for federal income tax purposes.

*Corporate Dividends.* We may exclude from our income 100% of dividends received from Territorial Savings Bank as a member of the same affiliated group of corporations.

*Audit of Tax Returns.* Territorial Bancorp Inc.'s 2011 federal income tax return was audited in 2013. The audit did not result in any material changes to the federal income tax return.

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**State Taxation**

Territorial Bancorp Inc. and Territorial Savings Bank are subject to a franchise tax imposed under Hawaii law at a rate of 7.92% of net income. The net income to which the tax rate is applied is determined in a manner consistent with the taxable income determined for federal purposes with some adjustments. The principal adjustment to federal taxable income is the inclusion of interest received on municipal bonds in gross income for Hawaii franchise tax purposes.

Territorial Bancorp Inc.'s state franchise tax returns have not been audited in the most recent five-year period.

**SUPERVISION AND REGULATION**

**General**

On June 25, 2014, Territorial Savings Bank converted from a federal savings bank to a Hawaii state-chartered savings bank. In addition, on July 10, 2014, Territorial Savings Bank became a member of the Federal Reserve System. As a result of these actions, Territorial Savings Bank is examined and supervised by the Hawaii Division of Financial Institutions, as its primary state regulator, and by the Board of Governors of the Federal Reserve System, or Federal Reserve Board, as its primary federal regulator. Territorial Savings Bank is also subject to examination by the Federal Deposit Insurance Corporation, its deposit insurer, under certain circumstances. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the Federal Deposit Insurance Corporation's deposit insurance fund and depositors, and not for the protection of security holders. Under this system of state and federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. The Hawaii Division of Financial Institutions and the Federal Reserve Board examine Territorial Savings Bank and prepare reports for the consideration of the Bank's Board of Directors on any operating deficiencies. Territorial Savings Bank's relationship with its depositors and borrowers also is regulated to a great extent by federal law and, to a much lesser extent, state law, especially in matters concerning the ownership of deposit accounts and the form and content of Territorial Savings Bank's loan documents.

Any change in these laws or regulations, whether by the Hawaii Division of Financial Institutions, the Federal Reserve Board, the Federal Deposit Insurance Corporation or Congress, could have a material adverse impact on Territorial Bancorp Inc., Territorial Savings Bank and their operations.

Territorial Bancorp Inc. maintained its status as a savings and loan holding company in connection with Territorial Savings Bank's charter conversion. Accordingly, Territorial Bancorp Inc. is required to file certain reports with, is subject to examination by, and otherwise must comply with the rules and regulations of the Federal Reserve Board. Territorial Bancorp Inc. is also subject to the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

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Certain of the regulatory requirements that are applicable to Territorial Savings Bank and Territorial Bancorp Inc. are described below. This description of statutes and regulations is not intended to be a complete description of such statutes and regulations and their effects on Territorial Savings Bank and Territorial Bancorp Inc. and is qualified in its entirety by reference to the actual statutes and regulations.



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The Dodd-Frank Wall Street Reform and Consumer Protection Act ( Dodd-Frank Act ), signed into law in 2010, eliminated our then-primary federal regulator, the Office of Thrift Supervision, by merging the Office of Thrift Supervision into the Office of the Comptroller of the Currency (the primary federal regulator for national banks). The Office of the Comptroller of the Currency assumed the responsibility for examining, regulating and enforcing laws and regulations against federal savings banks effective July 21, 2011. The legislation also established a Financial Services Oversight Council and granted the Board of Governors of the Federal Reserve System exclusive authority to regulate all bank and thrift holding companies. As a result, Territorial Bancorp Inc. became subject to supervision by the Federal Reserve Board as opposed to the Office of Thrift Supervision. Compliance with new regulations and being supervised by one or more new regulatory agencies could increase our expenses.

The Dodd-Frank Act also created a new agency, the Consumer Financial Protection Bureau, as an independent bureau of the Federal Reserve Board, to take over the implementation of federal consumer financial protection and fair lending laws from the depository institution regulators. However, institutions with \$10 billion or fewer in assets, such as Territorial Savings Bank, continue to be examined for compliance with such laws and regulations by the Federal Reserve Board, its primary banking regulator, rather than the Consumer Financial Protection Bureau.

The Dodd-Frank Act contained the so-called Volcker Rule, which generally prohibits banking organizations from engaging in proprietary trading and from investing in, sponsoring or having certain relationships with hedge or private equity funds ( covered funds ). On December 13, 2013, the federal agencies issued a final rule implementing the Volcker Rule which, among other things, requires banking organizations to restructure and limit certain of their investments in and relationships with covered funds. The final rule unexpectedly included within the interests subject to its restrictions collateralized debt obligations backed by trust-preferred securities ( TruPS CDOs ). Many banking organizations, including Territorial Savings Bank, had purchased such instruments because of their favorable tax, accounting and regulatory treatment and would have been subject to unexpected write-downs. In response to concerns expressed by community banking organizations, the federal agencies subsequently issued an interim final rule which grandfathers TruPS CDOs issued before May 19, 2010 if (i) acquired by a banking organization on or before December 10, 2013 and (ii) the organization reasonably believed the proceeds from the TruPS CDOs were invested primarily in any trust preferred security or subordinated debt instrument issued by a depository institution holding company with less than \$15 billion in assets or by a mutual holding company. Territorial Savings Bank's investment in TruPS CDOs is grandfathered by these new provisions and is further discussed in this 10-K report.

## **Federal Banking Regulation**

**Capital Requirements.** Federal regulations require federally insured depository institutions to meet several minimum capital standards: a common equity Tier 1 capital to risk-based assets ratio of 4.5%, a Tier 1 capital to risk-based assets ratio of 6.0%, a total capital to risk-based assets ratio of 8%, and a 4% Tier 1 capital to total assets leverage ratio. The current capital requirements were effective January 1, 2015 and are the result of a final rule implementing recommendations of the Basel Committee on Banking Supervision (BASEL III) and certain requirements of the Dodd-Frank Act.

In determining the amount of risk-weighted assets for purposes of calculating risk-based capital ratios, all assets, including certain off-balance sheet assets (e.g., recourse obligations, direct credit substitutes, residual interests) are multiplied by a risk weight factor assigned by the regulations based on the risks believed inherent in the type of asset. Higher levels of capital are required for asset categories believed to present greater risk. Common equity Tier 1 capital is generally defined as common stockholders' equity and retained earnings. Tier 1 capital is generally defined as common equity Tier 1 and additional Tier 1 capital. Additional Tier 1 capital includes certain noncumulative perpetual preferred



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stock and related surplus and minority interests in equity accounts of consolidated subsidiaries. Total capital includes Tier 1 capital (common equity Tier 1 capital plus additional Tier 1 capital) and Tier 2 capital. Tier 2 capital is comprised of capital instruments and related surplus, meeting specified requirements, and may include cumulative preferred stock and long-term perpetual preferred stock, mandatory convertible securities, intermediate preferred stock and subordinated debt. Also included in Tier 2 capital is the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and, for institutions that have exercised an opt-out election regarding the treatment of accumulated other comprehensive income, up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Calculation of all types of regulatory capital is subject to deductions and adjustments specified in the regulations. In assessing an institution's capital adequacy, the Federal Reserve Bank takes into consideration, not only these numeric factors, but qualitative factors as well, and has the authority to establish higher capital requirements for individual institutions where deemed necessary.

In addition to establishing the minimum regulatory capital requirements, the regulations limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted asset above the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement is being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented at 2.5% on January 1, 2019.

At December 31, 2015, Territorial Savings Bank's regulatory capital was considered to be well capitalized under the revised capital requirements, which became effective on January 1, 2015.

**Prompt Corrective Action Regulations.** Under prompt corrective action regulations, the Federal Reserve Board is authorized and, under certain circumstances, required to take supervisory actions against undercapitalized member banks. The extent of supervisory action depends upon the degree of the institution's undercapitalization. For this purpose, a member bank is placed in one of the following five categories based on the bank's capital:

- well-capitalized (at least 5% leverage capital, 8% Tier 1 risk-based capital, 10% total risk-based capital and 6.5% common equity Tier 1 risk-based capital);
  
- adequately capitalized (at least 4% leverage capital, 6% Tier 1 risk-based capital, 8% total risk-based capital and 4.5% common equity Tier 1 risk-based capital);
  
- undercapitalized (less than 4% leverage capital, 6% Tier 1 risk-based capital, 8% total risk-based capital or 4.5% common equity Tier 1 risk-based capital);
  
- significantly undercapitalized (less than 3% leverage capital, 4% Tier 1 risk-based capital, 6% total risk-based capital or 3% common equity Tier 1 risk-based capital); and

- critically undercapitalized (less than 2% tangible capital).

At December 31, 2015, Territorial Savings Bank met the criteria for being considered well-capitalized.

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**Capital Distributions.** Federal Reserve member banks must receive the prior approval of the Federal Reserve Board to pay dividends: (i) in an amount that exceeds the sum of the bank's net income during the calendar year and retained net income of the prior two calendar years or (ii) that would exceed the bank's undivided profits. Even if an application is not otherwise required, every savings bank that is a subsidiary of a savings and loan holding company must file a notice with the Federal Reserve Board at least 30 days before the Board of Directors declares a dividend.

The Federal Reserve Board may disapprove a notice or application if:

- the savings bank would be undercapitalized following the distribution;
- the proposed dividend raises safety and soundness concerns; or
- the dividend would violate a prohibition contained in any statute, regulation with a federal banking regulatory agency or any formal or informal enforcement action.

In addition, the Federal Deposit Insurance Act provides that an insured depository institution shall not make any capital distribution if, after making such distribution, the institution would be undercapitalized.

**Community Reinvestment Act and Fair Lending Laws.** All savings banks have a responsibility under the Community Reinvestment Act and related federal regulations to help meet the credit needs of their communities, including low- and moderate-income borrowers. In connection with its examination of a state member bank, the Federal Reserve Board is required to assess the savings bank's record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A savings bank's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in denial of certain corporate applications such as branches or mergers, or in restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the Federal Reserve Board, as well as other federal regulatory agencies and the Department of Justice. The Community Reinvestment Act requires all Federal Deposit Insurance Corporation-insured institutions to publicly disclose their rating. Territorial Savings Bank received a satisfactory Community Reinvestment Act rating in its most recent federal examination.

**Insurance of Deposit Accounts.** Territorial Savings Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation. Deposit insurance per account owner is \$250,000.

Under the Federal Deposit Insurance Corporation's risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned, and certain adjustments specified by Federal Deposit Insurance Corporation regulations. The Federal Deposit Insurance Corporation may adjust the scale uniformly, except that no adjustment can deviate more than two basis points from the base scale without notice and comment. No institution may pay a dividend if in default of the federal deposit insurance assessment.

The Dodd-Frank Act required the Federal Deposit Insurance Corporation to revise its procedures to base its assessments upon total assets less tangible equity instead of deposits. The Federal Deposit Insurance Corporation finalized a rule, effective April 1, 2011, that changed the assessment range to 2.5 to 45 basis points of total assets less tangible equity.

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In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. That payment is established quarterly and during the quarter ended December 31, 2015, equaled 0.60 basis points of total assets less tangible capital.

The Dodd-Frank Act increased the minimum target Deposit Insurance Fund ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The Federal Deposit Insurance Corporation must seek to achieve the 1.35% ratio by September 30, 2020. Insured institutions with assets of \$10 billion or more are supposed to fund the increase. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the Federal Deposit Insurance Corporation, and the Federal Deposit Insurance Corporation has exercised that discretion by establishing a long-range fund ratio of 2%.

The Federal Deposit Insurance Corporation has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

**Federal Home Loan Bank System.** Territorial Savings Bank is a member of the Federal Home Loan Bank System, which consists of eleven regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions as well as other entities involved in home mortgage lending. As a member of the Federal Home Loan Bank of Des Moines, Territorial Savings Bank is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of December 31, 2015, Territorial Savings Bank held \$4.8 million of capital stock in the Federal Home Loan Bank of Des Moines and was in compliance with this requirement.

**Hawaii Banking Regulation**

Authority granted by Hawaii laws includes accepting and holding deposits, borrowing from any source, making loans and extensions of credit of any kind, investing in service corporation subsidiaries engaged in activities permissible for service corporations of federal savings banks and engaging in other activities that are usual or incidental to the business of a savings bank. Hawaii law requires that at least 50% of a savings bank's loans and extensions of credit be secured by real estate. In addition, certain commercial loans are limited to 15% of the savings bank's assets and education loans are limited to 10% of assets.

Hawaii law generally limits a savings bank's capital distributions to the amount of its retained earnings.

Hawaii has a parity statute, which provides Hawaii savings banks with authority to engage in any activity permitted by federal law for federal savings banks, upon receiving the approval of the Commissioner. Territorial Savings Bank received such approval when it converted from a federal savings bank to a Hawaii savings bank.

**Other Regulations**

Territorial Savings Bank's operations are also subject to federal laws applicable to credit transactions, such as the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;



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- Real Estate Settlement Procedures Act, requiring that borrowers for mortgage loans for one- to four-family residential real estate receive various disclosures, including good faith estimates of settlement costs, lender servicing and escrow account practices, and prohibiting certain practices that increase the cost of settlement services;
  
- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
  
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
  
- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;
  
- fair lending laws;
  
- Unfair or Deceptive Acts or Practices ( UDAP ) laws and regulations;
  
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;
  
- Truth in Savings Act; and
  
- rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The operations of Territorial Savings Bank are further subject to the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services;
- Check Clearing for the 21<sup>st</sup> Century Act (also known as Check 21), which gives substitute checks, such as digital check images and copies made from that image, the same legal standing as the original paper check;
- The USA PATRIOT Act, which requires savings banks to, among other things, establish broadened anti-money laundering compliance programs, due diligence policies and controls to ensure the detection and reporting of money laundering. Such required compliance programs are intended to supplement existing compliance requirements, also applicable to financial institutions, under the Bank Secrecy Act and the Office of Foreign Assets Control regulations; and
- The Gramm-Leach-Bliley Act, which places limitations on the sharing of consumer financial information by financial institutions with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution's privacy policy and provide such customers the opportunity to opt out of the sharing of certain personal financial information with unaffiliated third parties.

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**Holding Company Regulation**

*General.* Territorial Bancorp Inc. is a nondiversified savings and loan holding company within the meaning of the Home Owners Loan Act. As such, Territorial Bancorp Inc. is registered with the Federal Reserve Board and subject to Federal Reserve Board regulations, examinations, supervision and reporting requirements. In addition, the Federal Reserve Board has enforcement authority over Territorial Bancorp Inc. and its subsidiaries. Among other things, this authority permits the Federal Reserve Board to restrict or prohibit activities that are determined to be a serious risk to the subsidiary savings institution. The Dodd-Frank Act regulatory restructuring transferred the responsibility for regulating and supervising savings and loan holding companies from the Office of Thrift Supervision to the Federal Reserve Board, effective July 21, 2011.

*Permissible Activities.* The business activities of Territorial Bancorp Inc. are generally limited to those activities permissible for financial holding companies under Section 4(k) of the Bank Holding Company Act of 1956, as amended, or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance as well as activities that are incidental to financial activities or complementary to a financial activity. The Dodd-Frank Act added that any savings and loan holding company that engages in activities permissible for a financial holding company must meet the qualitative requirements for a bank holding company to be a financial holding company and conduct the activities in accordance with the requirements that would apply to a financial holding company's conduct of the activity. A multiple savings and loan holding company is generally limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the Federal Reserve Board, and certain additional activities authorized by Federal Reserve Board regulations.

Federal law prohibits a savings and loan holding company, including Territorial Bancorp Inc., directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of another savings institution or holding company thereof, without prior written approval of the Federal Reserve Board. It also prohibits the acquisition or retention of, with certain exceptions, more than 5% of a nonsubsidiary company engaged in activities that are not closely related to banking or financial in nature, or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider the financial and managerial resources, future prospects of the company and institution involved, the effect of the acquisition on the risk to the federal deposit insurance fund, the convenience and needs of the community and competitive factors.

The Federal Reserve Board is prohibited from approving any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, subject to two exceptions:

- (i) the approval of interstate supervisory acquisitions by savings and loan holding companies; and

(ii) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisition.

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The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

**Capital.** Savings and loan holding companies have historically not been subject to specific regulatory capital requirements. The Dodd-Frank Act required the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. Instruments such as cumulative preferred stock and trust preferred securities are no longer includable as Tier 1 capital, as was previously the case with bank holding companies, subject to certain grandfathering. The previously discussed final rule regarding regulatory capital requirements implements this Dodd-Frank Act requirement as to savings and loan holding companies. Consolidated regulatory capital requirements identical to those applicable to the subsidiary depository institutions applied to savings and loan holding companies as of January 1, 2015. As is the case with institutions themselves, the capital conservation buffer for savings and loan holding companies will be phased in between 2016 and 2019.

**Source of Strength.** The Dodd-Frank Act also extended the source of strength doctrine to savings and loan holding companies. The Federal Reserve Board has issued regulations requiring that all bank and savings and loan holding companies serve as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

**Dividends and Stock Repurchases.** The Federal Reserve Board has issued a policy statement regarding the payment of dividends and the repurchase of shares of common stock by bank and savings and loan holding companies. In general, the policy provides that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. Regulatory guidance provides for prior regulatory review of capital distributions in certain circumstances, such as where the company's net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend. The guidance also provides for prior regulatory review where the company's overall rate of earnings retention is inconsistent with the company's capital needs and overall financial condition. The ability of a holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. The policy statement also provides for regulatory review prior to a holding company redeeming or repurchasing regulatory capital instruments when the holding company is experiencing financial weaknesses or redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction in the amount of such equity instruments outstanding as of the end of a quarter compared with the beginning of the quarter in which the redemption or repurchase occurred. These regulatory policies could affect the ability of Territorial Bancorp Inc. to pay dividends, repurchase shares of common stock or otherwise engage in capital distributions.

**Change in Control Regulations**

Under the Change in Bank Control Act, no person may acquire control of a savings and loan holding company such as the Company unless the Federal Reserve Board has been given 60 days' prior written notice and has not issued a notice disapproving the proposed acquisition, taking into

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consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Control, as defined under federal law, means ownership, control of or holding irrevocable proxies representing more than 25% of any class of voting stock, control in any manner of the election of a majority of the company's directors, or a determination by the regulator that the acquirer has the power to direct, or directly or indirectly to exercise a controlling influence over, the management or policies of the institution. Acquisition of more than 10% of any class of a savings and loan holding company's voting stock constitutes a rebuttable presumption of control under the regulations under certain circumstances including where, as is the case with Territorial Bancorp Inc., the issuer has registered securities under Section 12 of the Securities Exchange Act of 1934.

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**Federal Securities Laws**

Territorial Bancorp Inc.'s common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Territorial Bancorp Inc. is subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act of 1934.

Territorial Bancorp Inc. common stock held by persons who are affiliates (generally officers, directors and principal shareholders) of Territorial Bancorp Inc. may not be resold without registration unless sold in accordance with certain resale restrictions. If Territorial Bancorp Inc. meets specified current public information requirements, each affiliate of Territorial Bancorp Inc. is able to sell in the public market, without registration, a limited number of shares in any three-month period.

**Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. We have prepared policies, procedures and systems designed to ensure compliance with the Sarbanes-Oxley Act and related regulations.

**ITEM 1A. Risk Factors**

**Historically low interest rates may adversely affect our net interest income and profitability.**

In recent years it has been the policy of the Federal Reserve Board to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of mortgage-backed securities. As a result, interest rates on the loans we have originated and the yields on securities we have purchased have been at lower levels than available prior to 2008. As a general matter, our interest-bearing liabilities reprice or mature more quickly than our interest-earning assets, which has been one factor contributing to the increase in our interest rate spread as interest rates decreased. However, our ability to lower our interest expense continues to be limited since our cost of funds at December 31, 2015 is relatively low while the average yield on our interest-earning assets may continue to decrease as our higher yielding loans and securities are paid off. Accordingly, our net interest income may be adversely affected and may even decrease, which may have an adverse effect on our profitability.

**Future changes in interest rates could reduce our profits.**

Our ability to make a profit largely depends on our net interest income, which could be negatively affected by changes in interest rates. Net interest income is the difference between:

- the interest income we earn on our interest-earning assets, such as loans and securities; and
- the interest expense we pay on our interest-bearing liabilities, such as deposits and borrowings.



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As a result of our focus on one- to four-family residential real estate loans and the low demand for adjustable-rate loans in our market area, the interest rates we earn on our loans are generally fixed for long periods of time. Additionally, many of our securities investments are of long maturities with fixed interest rates. Like many savings institutions, our focus on deposit accounts as a source of funds, which have no stated maturity date or shorter contractual maturities than loans, results in our liabilities having a shorter duration than our assets. For example, as of December 31, 2015, 93.5% of our loans had maturities of 15 years or longer, while 73.7% of our certificates of deposits had maturities of one year or less. This imbalance can create significant earnings volatility, because market interest rates change over time. In a period of rising interest rates, the interest income earned on our assets, such as loans and investments, likely will not increase as rapidly as the interest paid on our liabilities, such as deposits. In a period of declining interest rates, the interest income earned on our assets likely will decrease more rapidly than the interest paid on our liabilities, as borrowers prepay mortgage loans and mortgage-backed securities, thereby requiring us to reinvest these cash flows at lower interest rates. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Management of Market Risk.

In addition, changes in interest rates can affect the average life of loans and mortgage-backed and related securities and the fair value of mortgage servicing assets. A reduction in interest rates results in increased prepayments of loans and mortgage-backed and related securities, as borrowers refinance their debt in order to reduce their borrowing costs. This creates reinvestment risk, which is the risk that we may not be able to reinvest prepayments at rates that are comparable to the rates we earned on the prepaid loans or securities. Additionally, increases in interest rates may decrease loan demand and/or make it more difficult for borrowers to repay adjustable-rate loans. Potential reduction, or impairment, to the fair value of mortgage servicing assets generally occurs as market interest rates decline. Alternatively, an increase in market interest rates generally causes an increase in the fair value of mortgage servicing assets.

Changes in interest rates also affect the current fair value of our interest-earning securities portfolio. Generally, the value of securities moves inversely with changes in interest rates. At December 31, 2015, the fair value of our investment in held-to-maturity securities totaled \$498.0 million. Net unrealized gains on these securities totaled \$4.9 million at December 31, 2015.

At December 31, 2015, our rate shock analysis indicated that our economic value of equity (the difference between the market value of our assets and the market value of our liabilities with adjustments made for off-balance sheet items) would decrease by \$9.7 million if there was an instantaneous 200 basis point increase in market interest rates. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Management of Market Risk.

**Our lending activities provide lower interest rates than financial institutions that originate more commercial loans.**

Our principal lending activity consists of originating one- to four-family residential real estate mortgage loans. As of December 31, 2015, these loans totaled \$1.146 billion or 95.9% of total loans. We originate our loans with a focus on limiting credit risk and not to generate the highest return or create the greatest difference between the yield on our interest-earning assets and our cost of funds (interest rate spread).

Residential real estate mortgage loans generally have lower interest rates than commercial business loans, commercial real estate loans and consumer loans. As a result, we may generate lower interest rate spreads and rates of return when compared to our competitors who originate more consumer or commercial loans than we do. We intend to continue our focus on residential real estate lending.



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**We could record future losses on our holding of a trust preferred security that we purchased from an issuer pool consisting primarily of financial institution holding companies. In addition, we may not receive full future principal or interest payments, or both, on this security.**

We owned a share of trust preferred security PreTSL XXIII with an adjusted cost basis and fair value of \$916,000 at December 31, 2015. PreTSL XXIII is a debt obligations issued by an issuer pool (Preferred Term Securities XXIII, Ltd. co-marketed by Keefe, Bruyette & Woods, Inc. and FTN Financial Capital Markets) consisting primarily of holding companies for Federal Deposit Insurance Corporation-insured financial institutions. This security is a Class D security, and was originated with a credit rating of BBB. As of December 31, 2015, PreTSL XXIII is rated C by Fitch.

Our investment in PreTSL XXIII was determined to be other-than-temporarily impaired as the present value of cash flows was lower than the amortized cost basis of the security. We recorded an impairment charge of \$2.4 million in the year ended December 31, 2010. When the impairment charge of \$2.4 million on PreTSL XXIII was recorded, the security was written down to its fair value of \$32,000. The book value of our investment in PreTSL XXIII has risen from \$32,000 to \$916,000 based on an increase in fair value which has occurred with an increase in the present value of cash flows from this security. The \$1.1 million difference between the original outstanding principal balance of \$3.5 million and the impairment charge of \$2.4 million was reported as other comprehensive loss and is related to noncredit factors such as an inactive trust preferred securities market.

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

A number of factors or combinations of factors could cause us to conclude in one or more future reporting periods that an unrealized loss that exists with respect to PreTSL XXIII constitutes an impairment that is other than temporary, which could result in material losses to us. These factors include, but are not limited to, continued failure to make scheduled interest or principal payments, an increase in the severity of the unrealized loss, an increase in the continuous duration of the unrealized loss without an improvement in value or changes in market conditions and/or industry or issuer specific factors that would render us unable to forecast a full recovery in value. In addition, the fair value of PreTSL XXIII could decline if the overall economy and the financial condition of some of the issuers deteriorate further and there remains limited liquidity for this security.

For the year ended December 31, 2015, we received no interest payments on the trust preferred security. The continued failure of the trust preferred issuers to make interest payments for any quarter will reduce our earnings during that quarter.

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The following table sets forth information with respect to this security as of December 31, 2015:

Pool Deal Name	Book Value	Fair Value	Unrealized Gain	Credit Rating (Dollars in Thousands)	Number of Financial Institutions in Pool	Deferrals and Defaults as a % of Collateral	Excess Subordination (1)
PreTSL XXIII	\$ 916	\$ 916	\$	C	101	21.9%	\$

(1) Estimated present value of future cash flows in excess of amortized cost basis, assuming that 50% of the security collateral is called in the 10<sup>th</sup> year following issuance.

**Changes in governmental programs or continuation and/or worsening of prevailing economic conditions could adversely affect our financial condition and results of operations.**

In October 2014, the Federal Reserve Board reported that conditions in the labor market have improved and the nation's unemployment rate has declined. Household spending has risen moderately and business investment is advancing while the recovery in the housing market remains slow. The Federal Reserve Board also indicated in October 2014 that it would no longer be buying mortgage-backed securities to increase the size of its securities portfolio. The Federal Reserve Board will continue to reinvest principal repayments on its securities portfolio into mortgage-backed securities. The change in the Federal Reserve Board's securities purchase program could result in higher interest rates and reduced economic activity. Moreover, a return to prolonged deteriorating economic conditions could significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing operations, costs and profitability. Declines in real estate values and sales volumes and increases in unemployment levels may result in greater loan delinquencies, increases in our nonperforming, criticized and classified assets and a decline in demand for our products and services. These events may cause us to incur losses and may adversely affect our financial condition and results of operations.

**Changes in laws and regulations and the cost of regulatory compliance with new laws and regulations may adversely affect our operations and our income.**

In response to the developments described above, Congress has taken actions that are intended to strengthen confidence and encourage liquidity in financial institutions, and the Federal Deposit Insurance Corporation has taken actions to increase insurance coverage on deposit accounts. In addition, there have been proposals made by members of Congress and others that would reduce the amount distressed borrowers are otherwise contractually obligated to pay under their mortgage loans and limit an institution's ability to foreclose on mortgage collateral.

The potential exists for additional federal or state laws and regulations, or changes in policy, regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Bank regulatory agencies, such as the Federal Reserve Board, the Hawaii Division of Financial Institutions and the Federal Deposit Insurance Corporation, govern the activities in which we may engage, primarily for the protection of depositors, and not for the protection or benefit of potential investors. In addition, new laws, regulations and other regulatory

changes may increase our costs of regulatory compliance and of doing business, and otherwise

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affect our operations. New laws, regulations, and other regulatory changes may significantly affect the markets in which we do business, the markets for and value of our loans and investments, and our ongoing operations, costs and profitability. Federal and state proposals limiting our rights as a creditor could result in credit losses or increased expense in pursuing our remedies as a creditor.

**Nonresidential real estate loans and commercial business loans increase our exposure to credit risks.**

At December 31, 2015, our portfolio of commercial real estate, construction and other nonresidential real estate loans totaled \$19.3 million, or 1.6% of total loans. In addition, at December 31, 2015, our portfolio of commercial business loans totaled \$3.8 million, or 0.3% of total loans. These loans generally expose us to a greater risk of nonpayment and loss than residential real estate loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential real estate loans.

We target our business lending and marketing strategy towards small- to medium-sized businesses. These small- to medium-sized businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. If general economic conditions adversely affect these businesses, our results of operations and financial condition may be negatively impacted. In addition, some of our commercial business loans are collateralized by a security interest in furniture, fixtures and equipment and the liquidation of collateral in the event of default is often an insufficient source of repayment because the collateral may have limited use or value.

**Strong competition within our market areas may limit our growth and profitability.**

Competition in the banking and financial services industry is intense. In our market areas, we compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies, and brokerage and investment banking firms operating locally. Some of our competitors have greater name recognition and market presence that benefit them in attracting business, and offer certain services that we do not or cannot provide. In addition, larger competitors may be able to price loans and deposits more aggressively than we do, which could affect our ability to grow and remain profitable on a long-term basis. Our profitability depends upon our continued ability to successfully compete in our market areas. If we must raise interest rates paid on deposits or lower interest rates charged on our loans, our net interest margin and profitability could be adversely affected. For additional information see Item 1. Business Competition.

**If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings will decrease.**

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, resulting in additions to our allowance. While our allowance for loan losses was 0.2% of total loans at December 31, 2015, material additions to our allowance could materially decrease our net income.

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In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities might have a material adverse effect on our financial condition and results of operations.

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**Our employee stock ownership plan may continue to increase our costs, which would reduce our income.**

Our employee stock ownership plan purchased 8% of the total shares of common stock sold in our stock offering using funds borrowed from Territorial Bancorp Inc. We record annual employee stock ownership plan expense in an amount equal to the fair value of the shares of common stock released to employees over the term of the loan. If the value of the shares of common stock continues to appreciate up to the time shares are released, compensation expense relating to the employee stock ownership plan will increase and our net income will decline.

**Our 2010 Equity Incentive Plan has increased our expenses and reduced our income, and may dilute your ownership interests.**

In August 2010, our stockholders approved the Territorial Bancorp Inc. 2010 Equity Incentive Plan. Stockholders approved the issuance of 736,434 shares of common stock pursuant to restricted stock and the issuance of 976,203 shares of common stock pursuant to stock options. During 2015, we recognized \$2.7 million in noninterest expense relating to this stock benefit plan.

We may fund the 2010 Equity Incentive Plan either through open market purchases or from the issuance of authorized but unissued shares of common stock. Our ability to repurchase shares of common stock to fund this plan will be subject to many factors, including, but not limited to, applicable regulatory restrictions on stock repurchases, the availability of stock in the market, the trading price of the stock, our capital levels, alternative uses for our capital and our financial performance. Our intention is to fund the plan through open market purchases and we have repurchased 3,099,253 shares as of December 31, 2015. However, stockholders would experience a reduction in ownership interest in the event newly issued shares of our common stock are used to fund stock options and restricted stock awards.

**Concentration of loans in our primary market area may increase risk.**

Our success depends primarily on the general economic conditions in the State of Hawaii, as nearly all of our loans are to customers in the state. Accordingly, the economic conditions in the State of Hawaii have a significant impact on the ability of borrowers to repay loans as well as our ability to originate new loans. As such, a decline in real estate valuations in this market would lower the value of the collateral securing those loans. In addition, significant weakening in general economic conditions such as inflation, recession, unemployment or other factors beyond our control could negatively affect our financial results.

**Our local economy relies heavily on the tourism industry. Downturns in this industry could affect our operations and results.**

Tourism is the largest sector of Hawaii's economy. The Hawaii Tourism Authority reported visitor arrivals and visitor spending grew by 4.1% and 2.3%, respectively, in 2015 compared to 2014. A downturn in the tourism industry, and the related loss of jobs or operating income for businesses, could have a significant impact on our ability to originate loans, and the ability of borrowers to repay loans, either of which could adversely affect our financial condition and results of operations.





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**Proposed reductions in defense spending by the federal government could have a detrimental impact on Hawaii's economy.**

The defense industry is the second largest contributor to Hawaii's economy after the visitor industry, contributing \$7.6 billion and creating thousands of jobs for residents of the State. The amount spent by the defense industry represents 9.9% of the State's gross domestic product. Proposals to cut defense and other general spending could have an adverse impact on Hawaii's economy, which could adversely affect our financial condition and results of operations.

**We are subject to extensive regulatory oversight.**

We and our subsidiaries are subject to extensive regulation and supervision. Regulators have intensified their focus on bank lending criteria and controls, and on the USA PATRIOT Act's anti-money laundering and Bank Secrecy Act compliance requirements. There also is increased scrutiny of our compliance practices generally and particularly with the rules enforced by the Office of Foreign Assets Control. Our failure to comply with these and other regulatory requirements could lead to, among other remedies, administrative enforcement actions and legal proceedings. In addition, the Dodd-Frank Act and implementing regulations are likely to have a significant effect on the financial services industry, which are likely to increase operating costs and reduce profitability. Regulatory or legislative changes could make regulatory compliance more difficult or expensive for us, and could cause us to change or limit some of our products and services, or the way we operate our business.

**Severe weather, natural disasters and other external events could significantly affect our operations and results.**

Because all of our office locations are in the State of Hawaii, severe weather or natural disasters, such as tsunamis, volcanic eruptions, hurricanes and earthquakes and other adverse external events, could have a significant effect on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Natural disasters, like the tsunami that occurred in Japan in 2011, could have an impact on the visitor industry in Hawaii. Accordingly, the occurrence of any such severe weather or natural disaster event could have a material adverse effect on our business, which, in turn, could adversely affect our financial condition and results of operations.

**We have become subject to more stringent capital requirements, which may adversely impact our return on equity, require us to raise additional capital, or constrain us from paying dividends or repurchasing shares.**

A final capital rule that became effective for financial institutions on January 1, 2015, includes new minimum risk-based capital and leverage ratios, and refines the definition of what constitutes capital for purposes of calculating these ratios. The new minimum capital requirements are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a capital conservation buffer of 2.5%, and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 to risk-based assets capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement is being phased in beginning in January 2016 at 0.625% of risk-weighted assets and increases each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer

amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions.

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Territorial Savings Bank and Territorial Bancorp Inc. met all of these new requirements, including the full 2.5% capital conservation buffer, as if these new requirements had been fully phased in as of December 31, 2015.

The application of more stringent capital requirements could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk-based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy, and could limit our ability to make distributions, including paying out dividends or buying back shares. Specifically, beginning in 2016, Territorial Savings Bank's ability to pay dividends will be limited if it does not have the capital conservation buffer required by the new capital rules, which may limit our ability to pay dividends to stockholders. See Supervision and Regulation Federal Banking Regulation Capital Distributions.

Territorial Savings Bank became a member of the Federal Reserve Bank of San Francisco in July 2014. The Federal Reserve Bank, as a condition of membership, requires that Territorial Savings Bank maintain a Tier 1 capital ratio of at least 9.0% for the next three years.

**Government responses to economic conditions may adversely affect our operations, financial condition and earnings.**

Newly enacted financial reform legislation has changed the bank regulatory framework, creating an independent consumer protection bureau that will assume the consumer protection responsibilities of the various federal banking agencies, and establish more stringent capital standards for banks and bank holding companies. The legislation has resulted in new regulations affecting the lending, funding, trading and investment activities of banks and bank holding companies. Bank regulatory agencies also have been responding aggressively to concerns and adverse trends identified in examinations. Ongoing uncertainty and adverse developments in the financial services industry and the domestic and international credit markets, and the effect of new legislation and regulatory actions in response to these conditions, may adversely affect our operations by restricting our business activities, including our ability to originate or sell loans, modify loan terms, or foreclose on property securing loans. These measures are likely to increase our costs of doing business and may have a significant adverse effect on our lending activities, financial performance and operating flexibility. In addition, these risks could affect the performance and value of our loan and investment securities portfolios, which also would negatively affect our financial performance.

Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the overall economy, has, among other things, kept interest rates low through its targeted federal funds rate and the purchase of mortgage-backed securities. If the Federal Reserve Board increases the federal funds rate, overall interest rates will likely rise, which may negatively impact the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

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**Noncompliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions.**

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions. During the last year, several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, these policies and procedures may not be effective in preventing violations of these laws and regulations.

**The building of market share through de novo branching could cause our expenses to increase faster than revenues.**

We intend to continue to build market share in the State of Hawaii through de novo branching. Since 2010, we have opened three de novo branches including the most recent branch opened in 2013. There are considerable costs involved in opening branches that generally require a period of time to generate the necessary revenues to offset their costs, especially in areas in which we do not have an established presence. Accordingly, any such business expansion can be expected to negatively impact our earnings for some period of time until certain economies of scale are reached. Our expenses could be further increased if we encounter delays in the opening of any of our new branches. Finally, our business expansion may not be successful after establishment.

**System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.**

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins, phishing and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. Although we, with the help of third-party service providers, intend to continue to implement security technology and establish operational procedures to prevent such damage, these security measures may not be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse effect on our financial condition and results of operations.

We mitigate this risk through guidance promulgated for all financial institutions by the Federal Financial Institutions Examination Council and the regulations issued under the Gramm-Leach-Bliley Act. This guidance also requires our core data processor to meet these standards. We regularly self-audit or review exams from auditors as well as federal banking regulators to assure that these standards are being met, internally as well as by our important data processing vendors. We also implemented firewall and other internal controls to protect our systems from compromise.



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Nevertheless, our system could be compromised and it is possible that significant amounts of time and money may be spent to rectify the harm caused by a breach or hack. While we have general liability insurance and cyber liability insurance, we know there are limitations on coverage as well as dollar amount. Furthermore, cyber incidents carry a greater risk of injury to our reputation. Finally, depending on the type of incident, banking regulators can impose restrictions on our business and consumer laws may require reimbursement of customer loss.

**Our risk management framework may not be effective in mitigating risk and reducing the potential for significant losses.**

Our risk management framework is designed to minimize risk and loss to us. We seek to identify, measure, monitor, report and control our exposure to risk, including strategic, market, liquidity, compliance and operational risks. While we use a broad and diversified set of risk monitoring and mitigation techniques, these techniques are inherently limited because they cannot anticipate the existence or future development of currently unanticipated or unknown risks. Recent economic conditions and heightened legislative and regulatory scrutiny of the financial services industry, among other developments, have increased our level of risk. Accordingly, we could suffer losses as a result of our failure to properly anticipate and manage these risks.

**Our business may be adversely affected by an increasing prevalence of fraud, including cyberfraud, and other financial crimes.**

Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud, including cyberfraud, and other financial crimes. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes. While we have policies and procedures designed to prevent such losses, losses may still occur.

**Legal and regulatory proceedings and related matters could adversely affect us or the financial services industry in general.**

We, and other participants in the financial services industry upon whom we rely to operate, have been and may in the future become involved in legal and regulatory proceedings. Most of the proceedings we consider to be in the normal course of our business or typical for the industry; however, it is inherently difficult to assess the outcome of these matters, and other participants in the financial services industry or we may not prevail in any proceeding or litigation. There could be substantial cost and management diversion in such litigation and proceedings, and any adverse determination could have a materially adverse effect on our business, brand or image, or our financial condition and results of our operations.

**We are a community bank and our ability to maintain our reputation is critical to the success of our business and the failure to do so may materially adversely affect our performance.**

We are a community bank, and our reputation is one of the most valuable components of our business. A key component of our business strategy is to rely on our reputation for customer service and knowledge of local markets to expand our presence by capturing new business opportunities from existing and prospective customers in our current market and contiguous areas. As such, we strive to conduct our business in

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a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values of being an integral part of the communities we serve, delivering superior service to our customers and caring about our customers and associates. If our reputation is



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negatively affected, by the actions of our employees, by our inability to conduct our operations in a manner that is appealing to current or prospective customers, or otherwise, our business and operating results may be adversely affected.

**The corporate governance provisions in our articles of incorporation and bylaws, and the corporate governance provisions under Maryland law, may prevent or impede the holders of our common stock from obtaining representation on our Board of Directors and may impede takeovers of the company that our board might conclude are not in the best interest of Territorial Bancorp Inc. or its stockholders.**

Provisions in our articles of incorporation and bylaws may prevent or impede holders of our common stock from obtaining representation on our Board of Directors and may make takeovers of Territorial Bancorp Inc. more difficult. For example, our Board of Directors is divided into three staggered classes. A classified board makes it more difficult for stockholders to change a majority of the directors because it generally takes at least two annual elections of directors for this to occur. Our articles of incorporation include a provision that no person will be entitled to vote any shares of our common stock in excess of 10% of our outstanding shares of common stock. This limitation does not apply to the purchase of shares by a tax-qualified employee stock benefit plan established by us. In addition, our articles of incorporation and bylaws restrict who may call special meetings of stockholders and how directors may be removed from office. Additionally, in certain instances, the Maryland General Corporation Law requires a supermajority vote of our stockholders to approve a merger or other business combination with a large stockholder, if the proposed transaction is not approved by a majority of our directors.

**Final regulations could restrict our ability to originate and sell loans.**

The Consumer Financial Protection Bureau has issued a rule designed to clarify for lenders how they can avoid legal liability under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower's ability to repay a mortgage. Loans that meet this qualified mortgage definition will be presumed to have complied with the new ability-to-repay standard. Under the Consumer Financial Protection Bureau's rule, a qualified mortgage loan must not contain certain specified features, including:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less bona fide discount points for prime loans);
- interest-only payments;
- negative-amortization; or
- terms longer than 30 years.

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Also, to qualify as a qualified mortgage, a loan must be made to a borrower whose total monthly debt-to-income ratio does not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower on the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments.

In addition, the Dodd-Frank Act requires the regulatory agencies to issue regulations that require securitizers of loans to retain not less than 5% of the credit risk for any asset that is not a qualified residential mortgage. The regulatory agencies have issued a final rule to implement this requirement. The final rule provides that the definition of qualified residential mortgage includes loans that meet the definition of qualified mortgage issued by the Consumer Financial Protection Bureau for purposes of its regulations.

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These rules could have a significant effect on the secondary market for loans and the types of loans we originate, and restrict our ability or desire to make certain types of loans or loans to certain borrowers, which could limit our growth or profitability.

**Our funding sources may prove insufficient to replace deposits at maturity and support our future growth.**

We must maintain sufficient funds to respond to the needs of depositors and borrowers. As a part of our liquidity management, we use a number of funding sources in addition to core deposit growth and repayments and maturities of loans and investments. As we continue to grow, we are likely to become more dependent on these sources, which may include Federal Home Loan Bank advances, securities sold under agreements to repurchase, proceeds from the sale of loans, federal funds purchased and brokered certificates of deposit. Adverse operating results or changes in industry conditions could lead to difficulty or an inability to access these additional funding sources. Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. If we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our operating margins and profitability would be adversely affected.

**We are subject to environmental liability risk associated with lending activities.**

A significant portion of our loan portfolio is secured by real estate, and we could become subject to environmental liabilities with respect to one or more of these properties. During the ordinary course of business, we may foreclose on and take title to properties securing defaulted loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous conditions or toxic substances are found on these properties, we may be liable for remediation costs, as well as for personal injury and property damage, civil fines and criminal penalties regardless of when the hazardous conditions or toxic substances first affected any particular property. Environmental laws may require us to incur substantial expenses to address unknown liabilities and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on nonresidential real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on us.

**Changes in management's estimates and assumptions may have a material impact on our consolidated financial statements and our financial condition or operating results.**

In preparing this annual report as well as other periodic reports we are required to file under the Securities Exchange Act of 1934, including our consolidated financial statements, our management is and will be required under applicable rules and regulations to make estimates and assumptions as of a specified date. These estimates and assumptions are based on management's best estimates and experience as of that date and are subject to substantial risk and uncertainty. Materially different results may occur as circumstances change and additional information becomes known. Areas requiring significant estimates and assumptions by management include our valuation of investment securities, our determination of our income tax provision, and our evaluation of the adequacy of our allowance for loan losses.

**ITEM 1B. Unresolved Staff Comments**

Not applicable.

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We operate from our corporate office in Honolulu, Hawaii, and from our 28 full-service branches located in the State of Hawaii. The net book value of our premises, land and equipment was \$4.9 million at December 31, 2015. The following table sets forth information with respect to our full-service banking offices, including the expiration date of leases with respect to leased facilities.

<b>AINA HAINA</b> Aina Haina Shopping Center 820 West Hind Drive Honolulu, Oahu 96821 4/30/2021	<b>KAILUA</b> 19 Oneawa Street Kailua, Oahu 96734	<b>KAUAI</b> Kukui Grove Shopping Center 4393 Kukui Grove Street Lihue, Kauai 96766 2/28/2018	<b>NUUANU</b> Nuuanu Shopping Center 1613 Nuuanu Avenue Honolulu, Oahu 96817 7/22/2021
<b>ALA MOANA CENTER</b> 1450 Ala Moana Boulevard Honolulu, Oahu 96814 12/31/2017	<b>KAIMUKI</b> 1108 12th Avenue Honolulu, Oahu 96816 12/31/2018	<b>KIHEI</b> Azeka Shopping Center 1279 South Kihei Road Kihei, Maui 96753 1/31/2019	<b>PEARL CITY</b> Pearl City Shopping Center 850 Kamehameha Highway Pearl City, Oahu 96782 9/22/2019
<b>DOWNTOWN</b> 1000 Bishop Street Honolulu, Oahu 96813 12/31/2020	<b>KALIHI-KAPALAMA</b> 1199 Dillingham Boulevard Honolulu, Oahu 96817 8/31/2017	<b>KONA</b> Crossroads Shopping Center 75-1027 Henry Street Kailua-Kona, Hawaii 96740 8/31/2020	<b>PEARLRIDGE</b> 98-084 Kamehameha Highway Aiea, Oahu 96701 6/30/2022
<b>HAWAII KAI</b> Hawaii Kai Shopping Center 377 Keahole Street Honolulu, Oahu 96825 9/30/2018	<b>KAMEHAMEHA SHOPPING CENTER</b> 1620 North School Street Honolulu, Oahu 96817 6/30/2025	<b>LAHAINA</b> Old Lahaina Center 170 Papalaua Street Lahaina, Maui 96761 3/31/2023	<b>PIIKOI</b> 1159 South Beretania Street Honolulu, Oahu 96814 12/31/2020
<b>HILO</b> Waiakea Center 315 Makaala Street Hilo, Hawaii 96720 12/31/2018	<b>KANEOHE</b> 46-005 Kawa Street Kaneohe, Oahu 96744 12/31/2019	<b>MANOA</b> Manoa Marketplace 2752 Woodlawn Drive Honolulu, Oahu 96822 7/10/2023	<b>SALT LAKE</b> Salt Lake Shopping Center 848 Ala Liliko Street Honolulu, Oahu 96818 1/31/2021
<b>KAHALA</b> 4819 Kilauea Avenue Honolulu, Oahu 96816 3/31/2020	<b>KAPAHULU</b> Kilohana Square 1016 Kapahulu Avenue Honolulu, Oahu 96816 11/14/2018	<b>McCULLY</b> 1111 McCully Street Honolulu, Oahu 96826 5/31/2018	<b>WAIPAHU</b> Waipahu Town Center 94-050 Farrington Highway Waipahu, Oahu 96797 12/31/2019

<b>KAHULUI</b>	<b>KAPOLEI</b>	<b>MILILANI</b>	<b>WAIPIO</b>
Queen Kaahumanu Center 275 W. Kaahumanu Avenue Kahului, Maui 96732 12/31/2019	Ace Center at Kapolei 480 Kamokila Boulevard Kapolei, Oahu 96709 7/31/2019	Town Center of Mililani 95-1249 Meheula Parkway Mililani, Oahu 96789 10/11/2019	Laniakea Plaza 94-1221 Ka Uka Boulevard Waipahu, Oahu 96797 9/30/2016

**ITEM 3.           Legal Proceedings**

From time to time, we are involved as plaintiff or defendant in various legal proceedings arising in the ordinary course of business. Except as previously disclosed, at December 31, 2015, we were not involved in any legal proceedings, the outcome of which we believe would be material to our financial condition or results of operations.

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Not applicable.

**PART II****ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

(a) **Market, Holder and Dividend Information.** Our common stock is traded on the NASDAQ Global Select Market under the symbol TBNK. The approximate number of holders of record of Territorial Bancorp Inc.'s common stock as of February 29, 2016 was 1,177. Certain shares of Territorial Bancorp Inc. are held in nominee or street name and, accordingly, the number of beneficial owners of such shares is not known or included in the foregoing number. The following table presents quarterly market and dividend information for Territorial Bancorp Inc.'s common stock for the two years ended December 31, 2015. The following information with respect to high and low closing prices was provided by the NASDAQ Global Select Market.

	High	Low	Dividends Declared Per Share
<b>Year Ended December 31, 2015</b>			
Quarter ended December 31, 2015	\$ 29.13	\$ 26.06	\$ 0.27
Quarter ended September 30, 2015	\$ 26.77	\$ 24.54	\$ 0.17
Quarter ended June 30, 2015	\$ 24.26	\$ 22.69	\$ 0.16
Quarter ended March 31, 2015	\$ 23.76	\$ 21.20	\$ 0.16
<b>Year Ended December 31, 2014</b>			
Quarter ended December 31, 2014	\$ 21.95	\$ 20.34	\$ 0.26
Quarter ended September 30, 2014	\$ 21.24	\$ 20.10	\$ 0.15
Quarter ended June 30, 2014	\$ 21.59	\$ 19.82	\$ 0.15
Quarter ended March 31, 2014	\$ 23.08	\$ 21.60	\$ 0.14

Dividend payments by Territorial Bancorp Inc. are dependent on dividends it receives from Territorial Savings Bank, because Territorial Bancorp Inc. has no source of income other than dividends from Territorial Savings Bank, earnings from the investment of proceeds from the sale of shares of common stock and interest payments with respect to Territorial Bancorp Inc.'s loan to the Employee Stock Ownership Plan. See Item 1. Business Supervision and Regulation Federal Banking Regulation Capital Distributions and Holding Company Regulation Dividends and Stock Repurchases.

(b) **Sales of Unregistered Securities.** Not applicable.

(c) *Use of Proceeds*. Not applicable.

(d) *Securities Authorized for Issuance Under Equity Compensation Plans*. See Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.



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(e) **Stock Repurchases.** The following table sets forth information in connection with repurchases of our shares of common stock during the fourth quarter of 2015:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs (1)
October 1, 2015 through October 31, 2015	18,098	\$ 26.04	18,098	20,637
November 1, 2015 through November 30, 2015				20,637
December 1, 2015 through December 31, 2015	20,637	28.89	20,637	
<b>Total</b>	<b>38,735</b>	<b>\$ 27.56</b>	<b>38,735</b>	

(1) On December 4, 2014, our Board of Directors authorized the repurchase of up to 400,000 shares of our common stock. The Company initially repurchased a total of 250,000 shares. Further repurchases were subject to the receipt of regulatory approvals or non-objections for the employee stock ownership plan to own 10% or more of the Company's outstanding shares of common stock. On July 1, 2015, the Company received the final regulatory approval needed for the ESOP to own more than 10% of the Company's common stock. In accordance with this authorization, we completed the repurchase of 400,000 shares of our common stock as of December 31, 2015. We have entered into a Rule 10b5-1 plan with respect to our stock repurchase plan.

(f) **Stock Performance Graph.** Set forth below is a stock performance graph comparing (a) the cumulative total return on our shares of common stock between December 31, 2010 and December 31, 2015, (b) the cumulative total return on stocks included in the Total Return Index for the NASDAQ Stock Market (US) over such period, and (c) the cumulative total return on stocks included in the SNL Bank and Thrift Index over such period. Cumulative return assumes the reinvestment of dividends, and is expressed in dollars based on an assumed investment of \$100.

There can be no assurance that the Company's stock performance will continue in the future with the same or similar trend depicted in the graph. The Company will not make or endorse any predictions as to future stock performance.

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The following selected financial data and ratios have been derived, in part, from the consolidated financial statements and notes appearing elsewhere in this annual report.

	2015	2014	Year Ended December 31, 2013		2012	2011
			(In thousands)			
<b>Selected Financial Condition Data:</b>						
Total assets	\$ 1,821,141	\$ 1,691,897	\$ 1,616,904	\$ 1,574,627	\$ 1,537,571	
Cash and cash equivalents	65,919	75,060	75,365	182,818	131,937	
Investment securities held to maturity	493,059	572,922	613,436	554,673	653,871	
Loans receivable, net	1,188,649	968,212	856,542	774,876	688,095	
Bank-owned life insurance	42,328	41,303	40,243	31,177	30,234	
Federal Home Loan Bank stock, at cost	4,790	11,234	11,689	12,128	12,348	
Deposits	1,445,103	1,359,679	1,288,709	1,237,847	1,166,116	
Federal Home Loan Bank advances	69,000	15,000	15,000	20,000	20,000	
Securities sold under agreements to repurchase	55,000	72,000	72,000	70,000	108,300	
Stockholders equity	219,641	216,378	212,140	218,972	213,961	

	2015	2014	Year Ended December 31, 2013		2012	2011
			(In thousands)			
<b>Selected Operating Data:</b>						
Interest and dividend income	\$ 63,092	\$ 59,615	\$ 56,175	\$ 60,149	\$ 62,733	
Interest expense	6,515	6,118	6,282	9,229	11,285	
Net interest income	56,577	53,497	49,893	50,920	51,448	
Provision for loan losses	455	360	39	415	418	
Net interest and dividend income after provision for loan losses	56,122	53,137	49,854	50,505	51,030	
Noninterest income	4,911	5,177	8,716	7,068	5,111	
Noninterest expense	36,499	35,308	35,077	34,438	34,654	
Income before income taxes	24,534	23,006	23,493	23,135	21,487	
Income taxes	9,786	8,909	8,846	8,297	8,698	
Net income	\$ 14,748	\$ 14,097	\$ 14,647	\$ 14,838	\$ 12,789	

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	At or For the Year Ended December 31,				
	2015	2014	2013	2012	2011
<b>Selected Financial Ratios and Other Data:</b>					
<b>Performance Ratios:</b>					
Return on average assets (ratio of net income to average total assets)	0.84%	0.85%	0.93%	0.95%	0.85%
Return on average equity (ratio of net income to average equity)	6.75%	6.54%	6.71%	6.78%	5.72%
Interest rate spread (1)	3.29%	3.30%	3.22%	3.25%	3.41%
Net interest margin (2)	3.36%	3.37%	3.28%	3.36%	3.55%
Efficiency ratio (3)	59.36%	60.18%	59.85%	59.39%	61.27%
Noninterest expense to average total assets	2.08%	2.13%	2.22%	2.20%	2.31%
Average interest-earning assets to average interest-bearing liabilities	115.86%	115.83%	117.07%	117.38%	118.21%
Average equity to average total assets	12.46%	13.02%	13.82%	13.97%	14.91%
Basic earnings per share	\$ 1.63	\$ 1.53	\$ 1.51	\$ 1.47	\$ 1.19
Diluted earnings per share	\$ 1.59	\$ 1.51	\$ 1.49	\$ 1.45	\$ 1.17
Dividend payout ratio	47.80%	46.36%	41.61%	37.24%	29.06%
<b>Asset Quality Ratios:</b>					
Nonperforming assets to total assets	0.30%	0.26%	0.37%	0.28%	0.22%
Nonperforming loans to total loans	0.45%	0.46%	0.69%	0.56%	0.42%
Allowance for loan losses to nonperforming loans	40.00%	37.97%	24.77%	37.95%	52.65%
Allowance for loan losses to total loans	0.18%	0.17%	0.17%	0.22%	0.22%
<b>Capital Ratios (bank-level only):</b>					
Total capital (to risk-weighted assets)	26.07%	29.93%	31.99%	36.87%	38.76%
Common equity Tier 1 capital (to risk-weighted assets) (4)	25.79%	n/a	n/a	n/a	n/a
Tier I capital (to risk-weighted assets)	25.79%	29.68%	31.75%	36.57%	38.47%
Tier I capital (to total assets)	11.49%	12.10%	12.35%	13.13%	13.07%
<b>Other Data:</b>					
Number of full-service offices	28	28	28	27	27
Full-time equivalent employees	275	268	274	271	258

(1) The average interest rate spread represents the difference between the weighted-average yield on interest-earning assets and the weighted-average cost of interest-bearing liabilities for the year.

(2) The net interest margin represents net interest income as a percent of average interest-earning assets for the year.

(3) The efficiency ratio represents noninterest expense divided by the sum of net interest income and noninterest income.

- (4) Effective January 1, 2015, a new common equity Tier 1 capital standard was implemented.

**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The objective of this section is to help readers understand our views on our results of operations and financial condition. You should read this discussion in conjunction with the consolidated financial statements and notes to the consolidated financial statements that appear elsewhere in this annual report.

**Overview**

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

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We have continued our focus on originating one- to four-family residential real estate loans. Our emphasis on conservative loan underwriting has resulted in low levels of nonperforming assets at a time when many financial institutions are experiencing significant asset quality issues. Our nonperforming assets totaled \$5.4 million, or 0.30% of total assets at December 31, 2015, compared to \$4.5 million, or 0.26% of total assets at December 31, 2014, and \$6.0 million, or 0.37% of total assets at December 31, 2013. As of December 31, 2015, nonperforming assets consisted primarily of 22 mortgage loans for \$5.4 million. Our nonperforming loans and loss experience has enabled us to maintain a relatively low allowance for loan losses in relation to other peer institutions and correspondingly resulted in low levels of provisions for loan losses. Our provisions for loan losses were \$455,000, \$360,000 and \$39,000 for the years ended December 31, 2015, 2014 and 2013, respectively.

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

Our operations in recent years have been affected by our efforts to manage our interest rate risk position. In 2015, we sold \$56.2 million of fixed-rate mortgage loans and obtained \$37.0 million of additional long-term, fixed-rate borrowings. In 2014, we sold \$37.5 million of fixed-rate mortgage loans. In 2013, we sold \$82.2 million of fixed-rate mortgage loans, obtained \$30.0 million of long-term, fixed-rate borrowings and purchased \$5.1 million of shorter-duration mortgage-backed securities. See Management of Market Risk for a discussion of the actions we took in 2015, 2014 and 2013 in managing interest rate risk.

Territorial Savings Bank's investments in mortgage-backed securities and collateralized mortgage obligations have been issued by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. These agencies guarantee the payment of principal and interest on the Bank's mortgage-backed securities. We do not own any preferred stock issued by Fannie Mae or Freddie Mac. As of December 31, 2015, our additional borrowing capacity at the Federal Home Loan Bank of Des Moines was \$555.1 million. As of December 31, 2014, our additional borrowing capacity at the Federal Home Loan Bank of Seattle was \$399.0 million.

**Critical Accounting Policies**

We consider accounting policies that require management to exercise significant judgment or discretion or make significant assumptions that have, or could have, a material impact on the carrying value of certain assets or on income, to be critical accounting policies. We consider the following to be our critical accounting policies:

**Allowance for Loan Losses.** We maintain an allowance for loan losses at an amount estimated to equal all credit losses incurred in our loan portfolio that are both probable and reasonable to estimate at a balance sheet date. To estimate credit losses on impaired loans (in accordance with the Receivables topic of the FASB ASC), we evaluate numerous factors, as described below in Allowance for Loan Losses. Based on our estimate of the level of allowance for loan losses required, we record a provision for loan losses to maintain the allowance for loan losses at an amount that

provides for all losses that are both probable and reasonable to estimate.

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Since we cannot predict with certainty the amount of loan charge-offs that will be incurred and because the eventual level of loan charge-offs is affected by numerous conditions beyond our control, a range of loss estimates can reasonably be used to determine the allowance for loan losses and the related provisions for loan losses. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review our allowance for loan losses. Such agencies may require that we recognize additions to the allowance for loan losses based on their judgments about information available to them at the time of their examination. Accordingly, actual results could differ materially from those estimates.

Deterioration in the Hawaii real estate market could result in an increase in loan delinquencies, additional increases in our allowance for loan losses and provision for loan losses, as well as an increase in loan charge-offs.

**Securities Impairment.** We periodically perform analyses to determine whether there has been an other-than-temporary decline in the value of our securities. Our held-to-maturity securities consist primarily of debt securities for which we have a positive intent and ability to hold to maturity, and are carried at amortized cost. Our available-for-sale securities are carried at fair value. We conduct a quarterly review and evaluation of the securities portfolio to determine if the value of any security has declined below its cost or amortized cost, and whether such decline is other-than-temporary. If such decline is deemed other-than-temporary, we would adjust the cost basis of the security by writing down the security for any credit losses through a charge on the income statement. The market values of our securities are affected by changes in interest rates as well as shifts in the market's perception of the issuers. The fair value of investment securities is usually based on quoted market prices or dealer quotes. However, if there are no observable market inputs (for securities such as trust preferred securities), we estimate the fair value using unobservable inputs. We discount projected cash flows using a risk-adjusted discount rate in accordance with the Fair Value Measurements and Disclosures topic of the FASB ASC.

Our investment in PreTSL XXIII was determined to be other-than-temporarily impaired and we recorded an impairment charge of \$2.4 million in the year ended December 31, 2010. PreTSL XXIII has a book value of \$916,000 at December 31, 2015. The difference between the book value of \$916,000 and the remaining unamortized cost basis of \$1.1 million is reported as other comprehensive loss and is related to noncredit factors such as an inactive trust preferred securities market.

See also Item 1A. Risk Factors for a discussion on our investment in trust preferred securities.

We evaluated our \$4.8 million investment in FHLB stock for other-than-temporary impairment as of December 31, 2015. Considering the long-term nature of this investment and the liquidity position of the FHLB of Des Moines, our FHLB stock was not considered other-than-temporarily impaired. As of December 31, 2015, the FHLB of Des Moines has met all of its regulatory capital requirements. Moody's Investor Services and Standard and Poor's have given the FHLB of Des Moines long-term credit ratings of Aaa and AA+, respectively.

We evaluated our \$3.0 million investment in FRB stock for other-than-temporary impairment as of December 31, 2015. Based on the long-term nature of this investment and the liquidity position of the FRB of San Francisco, our FRB stock was not considered to be other-than-temporarily impaired.





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**Deferred Tax Assets.** Deferred tax assets and liabilities are recognized for the estimated future tax effects attributable to temporary differences and carryforwards. A valuation allowance may be required if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. In determining whether a valuation allowance is necessary, we consider the level of taxable income in prior years, to the extent that carrybacks are permitted under current tax laws, as well as estimates of future taxable income and tax planning strategies that could be implemented to accelerate taxable income if necessary. If our estimates of future taxable income were materially overstated or if our assumptions regarding the tax consequences of tax planning strategies were inaccurate, some or all of our deferred tax assets may not be realized, which would result in a charge to earnings.

**Defined Benefit Retirement Plan.** Defined benefit plan obligations and related assets of our defined benefit retirement plan are presented in Note 17 to the Consolidated Financial Statements. Effective December 31, 2008, the defined benefit retirement plan was frozen and all plan benefits were fixed as of that date. Plan assets, which consist primarily of marketable equity securities and mutual funds, are typically valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries through the use of a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate and the expected long-term rate of return on plan assets. In determining the discount rate, we utilize a yield that reflects the top 50% of the universe of bonds, ranked in the order of the highest yield. These bonds provide cash flows that match the timing of expected benefit payments. Asset returns are based upon the anticipated average rate of earnings expected on the invested funds of the plans.

At December 31, 2015, we used weighted-average discount rates of 4.10% and 4.40% for calculating annual pension expense and projected plan liabilities, respectively, and an expected long-term rate of return on plan assets of 7.50% for calculating annual pension expense. At December 31, 2014, we used a weighted-average discount rate of 4.90% and 4.10% for calculating annual pension expense and projected plan liabilities, respectively, and an expected long-term rate of return on plan assets of 7.50% for calculating annual pension expense. For both the discount rate and the asset return rate, a range of estimates could reasonably have been used, which would affect the amount of pension expense and pension liability recorded.

A decrease in the discount rate or an increase in the asset return rate would reduce pension expense in 2015, while an increase in the discount rate or a decrease in the asset return rate would have the opposite effect. A 25 basis point decrease in the discount rate assumptions would decrease 2015 pension expense by \$3,000 and increase year-end 2015 pension liability by \$554,000, while a 25 basis point decrease in the asset return rate would increase 2015 pension expense by \$33,000.

**Balance Sheet Analysis**

**Assets.** At December 31, 2015, our assets were \$1.821 billion, an increase of \$129.2 million, or 7.6%, from \$1.692 billion at December 31, 2014. The increase was primarily caused by a \$220.4 million increase in loans receivable that occurred as loan production exceeded loan sales and repayments. This was partially offset by a \$79.9 million decrease in investment securities that occurred as repayments and sales exceeded purchases.

*Cash and Cash Equivalents.* At December 31, 2015, we had \$65.9 million of cash and cash equivalents compared to \$75.1 million at December 31, 2014. During 2015, cash and cash equivalents decreased by \$9.1 million primarily due to a \$220.4 million increase in loans receivable, \$8.9 million of common stock repurchases, a \$17.0 million decrease in securities sold under agreements to repurchase and the \$7.0 million payment of common stock dividends. These uses of cash were partially offset by an \$85.4 million increase in deposits, a \$79.9 million decrease in investment securities, a \$54.0 million increase in FHLB advances, net income of \$14.7 million, and a \$6.4 million decrease in FHLB stock.

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**Loan Portfolio Composition.** The following table sets forth the composition of our loan portfolio at the dates indicated.

	2015		2014		At December 31, 2013		2012		2011	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
(Dollars in thousands)										
<b>Real estate loans:</b>										
<b>First mortgage:</b>										
One- to four-family residential	\$ 1,145,904	95.90%	\$ 926,074	95.08%	\$ 823,273	95.41%	\$ 741,334	94.84%	\$ 654,412	94.13%
Multi-family residential	9,834	0.82	8,920	0.92	4,877	0.57	6,888	0.88	6,956	1.00
Construction, commercial and other	19,288	1.62	18,415	1.89	13,554	1.57	13,819	1.77	11,140	1.60
Home equity loans and lines of credit	15,333	1.28	15,992	1.64	16,524	1.91	15,202	1.94	17,253	2.48
Other loans	4,543	0.38	4,614	0.47	4,649	0.54	4,481	0.57	5,488	0.79
<b>Total loans</b>	<b>1,194,902</b>	<b>100.00%</b>	<b>974,015</b>	<b>100.00%</b>	<b>862,877</b>	<b>100.00%</b>	<b>781,724</b>	<b>100.00%</b>	<b>695,249</b>	<b>100.00%</b>
<b>Other items:</b>										
Unearned fees and discounts, net	(4,087)		(4,112)		(4,849)		(5,176)		(5,613)	
Allowance for loan losses	(2,166)		(1,691)		(1,486)		(1,672)		(1,541)	
Loans receivable, net	\$ 1,188,649		\$ 968,212		\$ 856,542		\$ 774,876		\$ 688,095	

**Loan Portfolio Maturities and Yields.** The following table summarizes the scheduled maturities of our loan portfolio at December 31, 2015. Demand loans, loans having no stated repayment schedule or maturity, and overdraft loans are reported as being due in one year or less.

Due During the Years Ending December 31,	One- to four-family residential real estate		Multi-family residential real estate		Construction, commercial and other real estate		Home equity loans and lines of credit		Other loans		Total	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
2016	\$ 2,845	5.23%	\$ 639	5.28%	\$ 209	7.00%	\$ 4	0.95%	\$ 744	6.81%	\$ 957	6.83%
2017 to 2020	2,845	5.23	639	5.28	2,132	5.39	3,093	5.35	726	5.65	9,435	5.34
2021 and beyond	1,143,059	4.05	9,195	4.65	16,947	4.58	12,236	4.07	3,073	4.99	1,184,510	4.06
<b>Total</b>	<b>\$ 1,145,904</b>	<b>4.05%</b>	<b>\$ 9,834</b>	<b>4.69%</b>	<b>\$ 19,288</b>	<b>4.70%</b>	<b>\$ 15,333</b>	<b>4.33%</b>	<b>\$ 4,543</b>	<b>5.39%</b>	<b>\$ 1,194,902</b>	<b>4.07%</b>



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The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at December 31, 2015 that are contractually due after December 31, 2016.

	Fixed	Due After December 31, 2016 Adjustable (In thousands)		Total
Real estate loans:				
First mortgage:				
One- to four-family residential	\$ 1,142,591	\$ 3,313		\$ 1,145,904
Multi-family residential	9,195	639		9,834
Construction, commercial and other	15,501	3,578		19,079
Home equity loans and lines of credit	2,987	12,342		15,329
Other loans	3,416	383		3,799
<b>Total loans</b>	<b>\$ 1,173,690</b>	<b>\$ 20,255</b>		<b>\$ 1,193,945</b>

**Securities.** At December 31, 2015, our securities portfolio totaled \$493.1 million, or 27.1% of assets. At that date, our securities held to maturity consisted of securities with the following amortized costs: \$481.5 million of mortgage-backed securities, \$10.7 million of collateralized mortgage obligations and \$916,000 of trust preferred securities. All of the mortgage-backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac or Ginnie Mae. At December 31, 2015, none of the underlying collateral consisted of subprime or Alt-A loans (traditionally defined as nonconforming loans having less than full documentation). At December 31, 2015, we held no common or preferred stock of Fannie Mae or Freddie Mac.

During the year ended December 31, 2015 our securities portfolio decreased by \$79.9 million, or 13.9%, primarily due to repayments and sales exceeding purchases.

The following table sets forth the amortized cost and estimated fair value of our securities portfolio at the dates indicated.

	2015		At December 31, 2014		2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)					
Held to Maturity:						
U.S. government sponsored mortgage-backed securities:						
Fannie Mae	\$ 174,947	\$ 175,432	\$ 204,184	\$ 207,000	\$ 200,058	\$ 191,717
Freddie Mac	249,473	254,515	292,890	302,943	331,753	326,707
Collateralized mortgage obligations (1)	10,668	10,349	17,315	17,178	26,238	25,853
Ginnie Mae	57,055	56,770	57,843	58,899	54,850	53,193
<b>Total U.S. government sponsored mortgage-backed securities</b>	<b>492,143</b>	<b>497,066</b>	<b>572,232</b>	<b>586,020</b>	<b>612,899</b>	<b>597,470</b>

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Trust preferred securities	916	916	690	690	537	537
Total	\$ 493,059	\$ 497,982	\$ 572,922	\$ 586,710	\$ 613,436	\$ 598,007

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(1) All of our collateralized mortgage obligations have been issued by Fannie Mae, Freddie Mac or Ginnie Mae.

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Any unrealized loss on individual mortgage-backed securities as of December 31, 2015, 2014 and 2013 was caused by increases in market interest rates. All of our mortgage-backed securities are guaranteed by U.S. government-sponsored enterprises or a U.S. government agency. Since the decline in market value has been attributable to changes in interest rates and not credit quality, we continue to have the intent not to sell these investments, and it is not more likely than not that we will be required to sell such investments prior to the recovery of the amortized cost basis, we have not considered these investments to be other-than-temporarily impaired as of December 31, 2015, 2014 or 2013.

At December 31, 2015, we owned a trust preferred security with an amortized cost of \$916,000. This security represents an investment in a pool of debt obligations issued primarily by holding companies of Federal Deposit Insurance Corporation-insured financial institutions.

The trust preferred securities market is considered to be inactive as only six transactions have occurred over the past 48 months in the same tranche of securities that we own and no new issues of pooled trust preferred securities have occurred since 2007. We 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%.

See also Item 1A. Risk Factors for a discussion on our investment in trust preferred securities.

At December 31, 2015, we had no investments in a single company (other than U.S. government sponsored enterprises) or entity that had an aggregate book value in excess of 10% of our consolidated stockholders' equity.



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**Portfolio Maturities and Coupons.** The composition and maturities of the investment securities portfolio at December 31, 2015 are summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur. No tax-equivalent adjustments have been made, as we did not hold any tax-free investment securities at December 31, 2015.

	One Year or Less		More than One Year through Five Years		More than Five Years through Ten Years		More than Ten Years		Total Securities		
	Weighted Amortized Cost	Average Coupon	Weighted Amortized Cost	Average Coupon	Weighted Amortized Cost	Average Coupon	Weighted Amortized Cost	Average Coupon	Amortized Cost	Fair Value	Weighted Average Coupon
(Dollars in thousands)											
Held to Maturity:											
U.S. government sponsored mortgage-backed securities:											
Fannie Mae	\$		% 28	4.54%	\$		% 174,919	3.13%	\$ 174,947	\$ 175,432	3.13%
Freddie Mac			4	4.50	7	5.00	249,462	3.32	249,473	254,515	3.32
Collateralized mortgage obligations (1)							10,668	2.12	10,668	10,349	2.12
Ginnie Mae							57,055	3.04	57,055	56,770	3.04
Total U.S. government sponsored mortgage-backed securities			32	4.54	7	5.00	492,104	3.19	492,143	497,066	3.19
Trust preferred securities							916	2.61	916	916	2.61
Total	\$		% 32	4.54%	\$ 7	5.00%	\$ 493,020	3.19%	\$ 493,059	\$ 497,982	3.19%

(1) All of our collateralized mortgage obligations have been issued by Fannie Mae, Freddie Mac or Ginnie Mae.

**Bank-Owned Life Insurance.** We invest in bank-owned life insurance to provide us with a funding source for our benefit plan obligations. Bank-owned life insurance also generally provides us noninterest income that is nontaxable. Interagency federal guidance generally limits our investment in bank-owned life insurance to 25% of the Bank's Tier 1 capital plus our allowance for loan losses. At December 31, 2015, this limit was \$52.6 million, and we had invested \$42.3 million in bank-owned life insurance at that date.

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**Deposits.** We accept deposits primarily from the areas in which our offices are located. We rely on our competitive pricing, convenient locations and customer service to attract and retain deposits. We offer a variety of deposit accounts with a range of interest rates and terms. Our deposit accounts consist of passbook and statement savings accounts, certificates of deposit, money market accounts, commercial and regular checking accounts and Super NOW accounts. Historically, we have not accepted brokered deposits.

Interest rates paid, maturity terms, service fees and withdrawal penalties are established on a periodic basis. Deposit rates and terms are based primarily on current operating strategies, market interest rates, liquidity requirements and our deposit growth goals.

During the year ended December 31, 2015, our deposits grew by \$85.4 million, or 6.3%. The increase was caused primarily by our strategy of promoting higher-than-market rates for our passbook and statement savings accounts. Savings accounts grew by \$56.8 million, or 6.0%, because of the higher interest rates offered. We also believe that the ability to get immediate access to their funds without incurring an early withdrawal penalty appeals to customers.

At December 31, 2015, we had a total of \$224.0 million in certificates of deposit, of which \$165.0 million had remaining maturities of one year or less. Based on historical experience and our current pricing strategy, we believe we will retain a significant portion of these accounts upon maturity.

The following tables set forth the distribution of our average total deposit accounts (including interest-bearing and non-interest-bearing deposits), by account type, for the periods indicated.

	For the Year Ended December 31,					
	2015			2014		
Deposit type:	Average Balance	Percent	Weighted Average Rate (Dollars in thousands)	Average Balance	Percent	Weighted Average Rate
Non-interest-bearing	\$ 43,591	3.1%	%	\$ 36,812	2.8%	%
Savings accounts	965,754	69.3	0.38%	926,080	70.0	0.36%
Certificates of deposit	225,048	16.2	0.50%	215,127	16.3	0.50%
Money market	1,117	0.1	0.27%	801	0.1	0.25%
Checking and Super NOW	156,776	11.3	0.02%	142,726	10.8	0.02%
<b>Total deposits</b>	<b>\$ 1,392,286</b>	<b>100.0%</b>	<b>0.35%</b>	<b>\$ 1,321,546</b>	<b>100.0%</b>	<b>0.34%</b>

For the Year Ended December 31, 2013		
Average Balance	Percent	Weighted Average Rate
(Dollars in thousands)		

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<b>Deposit type:</b>				
Non-interest-bearing	\$	31,863	2.6%	%
Savings accounts		889,986	71.2	0.34%
Certificates of deposit		197,604	15.8	0.62%
Money market		761	0.1	0.26%
Checking and Super NOW		129,160	10.3	0.02%
Total deposits	\$	1,249,374	100.0%	0.34%

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As of December 31, 2015, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to \$100,000 was \$172.2 million. The following table sets forth the maturity of those certificates as of December 31, 2015.

At December 31, 2015 (In thousands)	
Three months or less	\$ 97,017
Over three months through six months	41,296
Over six months through one year	5,581
Over one year to three years	8,911
Over three years	19,423
<b>Total</b>	<b>\$ 172,228</b>

**Borrowings.** Our borrowings consist of advances from the Federal Home Loan Bank and funds borrowed under securities sold under agreements to repurchase. At December 31, 2015, our Federal Home Loan Bank advances totaled \$69.0 million, or 4.3% of total liabilities and our securities sold under agreements to repurchase totaled \$55.0 million, or 3.4% of total liabilities. At December 31, 2015, we had the capability to borrow up to \$555.1 million in the form of additional advances from the Federal Home Loan Bank.

During the year ended December 31, 2015, our borrowings increased by \$37.0 million, or 42.5%. The increase occurred when we had a \$54.0 million net increase in Federal Home Loan Bank advances that was partially offset by a \$17.0 million net pay off 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.

The following table sets forth information concerning balances and interest rates on our Federal Home Loan Bank advances at the dates and for the years indicated.

	At or For the Year Ended December 31,		
	2015	2014	2013
(Dollars in thousands)			
Balance at end of year	\$ 69,000	\$ 15,000	\$ 15,000
Average balance during year	\$ 46,186	\$ 15,000	\$ 15,836
Maximum outstanding at any month end	\$ 69,000	\$ 15,000	\$ 20,000
Weighted average interest rate at end of year	1.49%	1.77%	1.77%
Average interest rate during year	1.51%	1.77%	1.91%

The following table sets forth information concerning balances and interest rates on our securities sold under agreements to repurchase at the dates and for the years indicated.

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	At or For the Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Balance at end of year	\$ 55,000	\$ 72,000	\$ 72,000
Average balance during year	\$ 60,014	\$ 72,000	\$ 64,111
Maximum outstanding at any month end	\$ 72,000	\$ 72,000	\$ 72,000
Weighted average interest rate at end of year	1.57%	1.88%	1.88%
Average interest rate during year	1.66%	1.88%	2.63%

**Stockholders Equity.** At December 31, 2015, our stockholders equity was \$219.6 million, an increase of \$3.3 million, or 1.5%, from \$216.4 million at December 31, 2014. The increase in stockholders equity primarily resulted from net income of \$14.7 million, a \$3.1 million increase in paid-in-capital related to share-based compensation awards and a \$1.2 million increase due to the allocation of ESOP shares. This was partially offset by the declaration of \$7.0 million of dividends during the year ended December 31, 2015 and \$8.9 million spent to repurchase 373,711 shares of our common stock.

Table of Contents**Average Balances and Yields**

The following tables set forth average balance sheets, average yields and rates, and certain other information for the years indicated. No tax-equivalent yield adjustments were made, as we did not hold any tax-free investments. 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.

	<b>For the Year Ended December 31, 2015</b>		
	<b>Average Outstanding Balance</b>	<b>Interest</b>	<b>Yield/ Rate</b>
	<b>(Dollars in thousands)</b>		
<b>Interest-earning assets:</b>			
Loans:			
Real estate loans:			
First mortgage:			
One- to four-family residential (1)	\$ 1,050,352	\$ 43,654	4.16%
Multi-family residential	9,692	459	4.74
Construction, commercial and other	18,110	837	4.62
Home equity loans and lines of credit	15,560	709	4.56
Other loans	4,502	244	5.42
Total loans	1,098,216	45,903	4.18
Investment securities:			
U.S. government sponsored mortgage-backed securities (1)	529,535	16,873	3.19
Trust preferred securities	790		
Total securities	530,325	16,873	3.18
Other	57,147	316	0.55
Total interest-earning assets	1,685,688	63,092	3.74
Non-interest-earning assets	67,486		
Total assets	\$ 1,753,174		
<b>Interest-bearing liabilities:</b>			
Savings accounts	\$ 965,754	3,670	0.38%
Certificates of deposit	225,048	1,115	0.50
Money market accounts	1,117	3	0.27
Checking and Super NOW accounts	156,776	33	0.02
Total interest-bearing deposits	1,348,695	4,821	0.36
Federal Home Loan Bank advances	46,186	697	1.51
Securities sold under agreements to repurchase	60,014	997	1.66
Total interest-bearing liabilities	1,454,895	6,515	0.45
Non-interest-bearing liabilities	79,762		
Total liabilities	1,534,657		
Stockholders' equity	218,517		
Total liabilities and stockholders' equity	\$ 1,753,174		
Net interest income		\$ 56,577	
Net interest rate spread (2)			3.29%
Net interest-earning assets (3)	\$ 230,793		
Net interest margin (4)			3.36%
	115.86%		

Interest-earning assets to interest-bearing liabilities

*(footnotes on following page)*

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	For the Year Ended December 31,					
	2014			2013		
	Average Outstanding Balance	Interest	Yield/ Rate (Dollars in thousands)	Average Outstanding Balance	Interest	Yield/ Rate
<b>Interest-earning assets:</b>						
Loans:						
Real estate loans:						
First mortgage:						
One- to four-family residential (1)	\$ 859,541	\$ 37,411	4.35%	\$ 780,556	\$ 34,905	4.47%
Multi-family residential	4,990	278	5.57	5,706	328	5.75
Construction, commercial and other	18,332	904	4.93	13,397	661	4.93
Home equity loans and lines of credit	15,709	760	4.84	15,237	805	5.28
Other loans	4,653	267	5.74	4,728	283	5.99
Total loans	903,225	39,620	4.39	819,624	36,982	4.51
Investment securities:						
U.S. government sponsored mortgage-backed securities (1)	604,651	19,752	3.27	580,600	18,941	3.26
Trust preferred securities	628			494		
Total securities	605,279	19,752	3.26	581,094	18,941	3.26
Other	80,339	243	0.30	118,252	252	0.21
Total interest-earning assets	1,588,843	59,615	3.75	1,518,970	56,175	3.70
Non-interest-earning assets	65,511			60,356		
Total assets	\$ 1,654,354			\$ 1,579,326		
<b>Interest-bearing liabilities:</b>						
Savings accounts	\$ 926,080	3,369	0.36%	\$ 889,986	3,035	0.34%
Certificates of deposit	215,127	1,073	0.50	197,604	1,231	0.62
Money market accounts	801	2	0.25	761	2	0.26
Checking and Super NOW accounts	142,726	30	0.02	129,160	28	0.02
Total interest-bearing deposits	1,284,734	4,474	0.35	1,217,511	4,296	0.35
Federal Home Loan Bank advances	15,000	266	1.77	15,836	302	1.91
Securities sold under agreements to repurchase	72,000	1,378	1.91	64,111	1,684	2.63
Total interest-bearing liabilities	1,371,734	6,118	0.45	1,297,458	6,282	0.48
Non-interest-bearing liabilities	67,164			63,567		
Total liabilities	1,438,898			1,361,025		
Stockholders equity	215,456			218,301		
Total liabilities and stockholders equity	\$ 1,654,354			\$ 1,579,326		
Net interest income		\$ 53,497			\$ 49,893	
Net interest rate spread (2)			3.30%			3.22%
Net interest-earning assets (3)	\$ 217,109			\$ 221,512		
Net interest margin (4)			3.37%			3.28%
Interest-earning assets to interest-bearing liabilities	115.83%			117.07%		

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

(2) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.



- (3) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
- (4) Net interest margin represents net interest income divided by average total interest-earning assets.

Table of Contents**Rate/Volume Analysis**

The following table presents the effects of changing rates and volumes on our net interest income for the years indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The total column represents the sum of the prior columns. For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately based on the changes due to rate and the changes due to volume.

	Year Ended December 31, 2015 vs. 2014			Year Ended December 31, 2014 vs. 2013		
	Increase (Decrease) Due to		Total Increase (Decrease) (In thousands)	Increase (Decrease) Due to		Total Increase (Decrease)
	Volume	Rate		Volume	Rate	
<b>Interest-earning assets:</b>						
Loans:						
Real estate loans:						
First mortgage:						
One- to four-family residential	\$ 7,835	\$ (1,592)	\$ 6,243	\$ 3,404	\$ (898)	\$ 2,506
Multi-family residential	215	(34)	181	(40)	(10)	(50)
Construction, commercial and other	(11)	(56)	(67)	243		243
Home equity loans and lines of credit	(7)	(44)	(51)	26	(71)	(45)
Other loans	(8)	(15)	(23)	(4)	(12)	(16)
Total loans	8,024	(1,741)	6,283	3,629	(991)	2,638
U.S. government sponsored mortgage-backed securities	(2,403)	(476)	(2,879)	786	25	811
Other	(39)	112	73	29	(38)	(9)
Total interest-earning assets	5,582	(2,105)	3,477	4,444	(1,004)	3,440
<b>Interest-bearing liabilities:</b>						
Savings accounts	147	154	301	126	208	334
Certificates of deposit	49	(7)	42	127	(285)	(158)
Money market accounts	1		1			
Checking and Super NOW accounts	3		3	3	(1)	2
Total interest-bearing deposits	200	147	347	256	(78)	178
Federal Home Loan Bank advances	464	(33)	431	(15)	(21)	(36)
Securities sold under agreements to repurchase	(213)	(168)	(381)	254	(560)	(306)
Total interest-bearing liabilities	451	(54)	397	495	(659)	(164)
Change in net interest income	\$ 5,131	\$ (2,051)	\$ 3,080	\$ 3,949	\$ (345)	\$ 3,604



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**Comparison of Operating Results for the Years Ended December 31, 2015, 2014 and 2013**

**General.** Net income increased by \$651,000, or 4.6%, to \$14.7 million for the year ended December 31, 2015 from \$14.1 million for the year ended December 31, 2014. The increase in net income was caused by a \$3.5 million increase in interest and dividend income due primarily to a higher average loan balance. This was partially offset by a \$1.2 million increase in noninterest expense, an \$877,000 increase in income tax expense, a \$397,000 increase in interest expense, and a \$266,000 decrease in noninterest income.

Net income decreased by \$550,000, or 3.8%, to \$14.1 million for the year ended December 31, 2014 from \$14.6 million for the year ended December 31, 2013. The decrease in net income was caused by a \$3.5 million decline in noninterest income due to a decrease in gains on sale of securities and loans, a \$321,000 increase in the provision for loan losses and a \$231,000 increase in noninterest expense. This was partially offset by a \$3.4 million increase in interest and dividend income due to higher average loan and investment security balances, and a \$164,000 decline in interest expense due to a lower average rate on borrowings.

**Net Interest Income.** Net interest income increased by \$3.1 million, or 5.8%, to \$56.6 million for the year ended December 31, 2015 from \$53.5 million for the year ended December 31, 2014. Interest and dividend income increased by \$3.5 million, or 5.8%, to \$63.1 million for the year ended December 31, 2015 from \$59.6 million for the year ended December 31, 2014. The increase in interest and dividend income occurred primarily because of a \$96.8 million increase in average interest-earning assets which was partially offset by a one basis point decline in the average yield on interest-earning assets. Interest expense increased by \$397,000, or 6.5%, to \$6.5 million for the year ended December 31, 2015 from \$6.1 million for the year ended December 31, 2014. The increase in interest expense is due to an \$83.2 million increase in average interest-bearing liabilities. The interest rate spread and net interest margin were 3.29% and 3.36%, respectively, for the year ended December 31, 2015, compared to 3.30% and 3.37% for 2014.

Net interest income increased by \$3.6 million, or 7.2%, to \$53.5 million for the year ended December 31, 2014 from \$49.9 million for the year ended December 31, 2013. Interest and dividend income increased by \$3.4 million, or 6.1%, to \$59.6 million for the year ended December 31, 2014 from \$56.2 million for the year ended December 31, 2013. The increase in interest and dividend income occurred primarily because of a \$69.9 million increase in average interest-earning assets and a five basis point increase in the average interest-earning asset yield. Interest expense decreased by \$164,000, or 2.6%, to \$6.1 million for the year ended December 31, 2014 from \$6.3 million for the year ended December 31, 2013. The decrease in interest expense is primarily due to a three basis point decline in the average cost of interest-bearing liabilities that was partially offset by a \$74.3 million increase in average interest-bearing liabilities. The interest rate spread and net interest margin were 3.30% and 3.37%, respectively, for the year ended December 31, 2014, compared to 3.22% and 3.28% for 2013. The eight basis point increase in the net interest rate spread is due to a five basis point increase in the average yield on interest-earning assets and a three basis point decline in the cost of interest-bearing liabilities. The decrease in the cost of interest-bearing liabilities resulted from lower market interest rates.

**Interest and Dividend Income.** Interest and dividend income rose by \$3.5 million, or 5.8%, to \$63.1 million for the year ended December 31, 2015 from \$59.6 million for the year ended December 31, 2014. Interest income on loans increased by \$6.3 million, or 15.9%, to \$45.9 million for the year ended December 31, 2015 from \$39.6 million for

the year ended December 31, 2014. The growth in interest income on loans occurred because the average balance of loans grew by \$195.0 million, or 21.6%, as new loan originations exceeded loan repayments and loan sales. This increase in interest income that occurred because of growth in the loan portfolio was partially offset by a 21 basis point decline in the average loan yield to 4.18% for the year ended December 31, 2015 compared to 4.39% for the year ended December 31, 2014. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and the origination of new loans with lower yields. Interest income on investment securities decreased by \$2.9 million, or 14.6%, to \$16.9 million for the year ended December 31, 2015 from \$19.8 million for the year ended December 31, 2014. The decrease in

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interest income on securities occurred primarily because of a \$75.0 million decrease in the average securities balance and an eight basis point decline in the average investment yield to 3.18% for the year ended December 31, 2015 compared to 3.26% for the year ended December 31, 2014. The decrease in the average securities balance occurred as repayments and security sales exceeded security purchases.

Interest and dividend income rose by \$3.4 million, or 6.1%, to \$59.6 million for the year ended December 31, 2014 from \$56.2 million for the year ended December 31, 2013. Interest income on loans increased by \$2.6 million, or 7.1%, to \$39.6 million for the year ended December 31, 2014 from \$37.0 million for the year ended December 31, 2013. The growth in interest income on loans occurred because the average balance of loans grew by \$83.6 million, or 10.2%, as new loan originations exceeded loan repayments and loan sales. This increase in interest income that occurred because of growth in the loan portfolio was partially offset by a 12 basis point decline in the average loan yield to 4.39% for the year ended December 31, 2014 compared to 4.51% for the year ended December 31, 2013. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and the origination of new loans with lower yields. Interest income on investment securities rose by \$811,000, or 4.3%, to \$19.8 million for the year ended December 31, 2014 from \$18.9 million for the year ended December 31, 2013. The increase in interest income on securities occurred primarily because of a \$24.2 million increase in the average securities balance. The increase in the average securities balance occurred as the purchase of securities exceeded repayments and the amount of securities sold.

**Interest Expense.** Interest expense increased by \$397,000, or 6.5%, to \$6.5 million for the year ended December 31, 2015 from \$6.1 million for the year ended December 31, 2014. Interest expense on FHLB advances increased by \$431,000, or 162.0%, during the year ended December 31, 2015 compared to the year ended December 31, 2014. The increase in interest expense on FHLB advances was due to a \$31.2 million increase in the average balance of FHLB advances. This was partially offset by a 26 basis point decrease in the average interest rate to 1.51% for the year ended December 31, 2015 compared to 1.77% for the year ended December 31, 2014. Additional advances were obtained during the year ended December 31, 2015 to extend the maturity of liabilities and reduce interest rate risk. Interest expense on deposits increased by \$347,000, or 7.8%, to \$4.8 million for the year ended December 31, 2015 from \$4.5 million for the year ended December 31, 2014. The increase in interest expense on deposits is primarily due to a \$64.0 million, or 5.0% increase in the average balance of deposits. The average balance of deposits grew to \$1.349 billion during the year ended December 31, 2015 compared to \$1.285 billion during the year ended December 31, 2014. Interest expense on securities sold under agreements to repurchase declined by \$381,000, or 27.6%, during the year ended December 31, 2015 compared to the year ended December 31, 2014. The decrease in interest expense on securities sold under agreements to repurchase was caused by a \$12.0 million, or 16.6%, decrease in the average outstanding balance of securities sold under agreements to repurchase. The decrease in the average balance was augmented by a 25 basis point decrease in the average interest rate to 1.66% for the year ended December 31, 2015 compared to 1.91% for the year ended December 31, 2014. The decline in the average balance of securities sold under agreements to repurchase occurred as the Company paid off matured borrowings.

Interest expense decreased by \$164,000, or 2.6%, to \$6.1 million for the year ended December 31, 2014 from \$6.3 million for the year ended December 31, 2013. Interest expense on securities sold under agreements to repurchase declined by \$306,000, or 18.2%, during the year ended December 31, 2014. The decrease in interest expense on securities sold under agreements to repurchase was caused by a 72 basis point decrease in the average interest rate to 1.91% for the year ended December 31, 2014 compared to 2.63% for the year ended December 31, 2013, which occurred as higher costing agreements matured and were refinanced at lower rates in 2013. The decline in the average rate on securities sold under agreements to repurchase was partially offset by a \$7.9 million, or 12.3%, growth in the average outstanding balance of securities sold under agreements to repurchase. Interest expense on FHLB advances decreased by \$36,000, or 11.9%, during the year ended December 31, 2014 compared to the year ended December 31, 2013. The decline in interest expense on FHLB advances was caused by an \$836,000, or 5.3%, decrease in the average balance of FHLB advances and a 14 basis point decrease in the average interest rate to 1.77% for the year ended December 31, 2014 compared to 1.91% for the year ended



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December 31, 2013. The decrease in the average interest rate on FHLB advances occurred as higher costing advances matured and were refinanced at lower interest rates. Interest expense on deposits increased by \$178,000, or 4.1%, to \$4.5 million for the year ended December 31, 2014 from \$4.3 million for the year ended December 31, 2013. The average balance of deposits rose by \$67.2 million, or 5.5%, to \$1.285 billion during the year ended December 31, 2014 compared to \$1.218 billion during the year ended December 31, 2013.

**Provision for Loan Losses.** Based on our analysis of the factors described in Allowance for Loan Losses, we recorded provisions for loan losses of \$455,000, \$360,000 and \$39,000 for the years ended December 31, 2015, 2014 and 2013, respectively. The increase in loan loss provisions is primarily due to an increase in the size of the loan portfolio. The provisions for loan losses included a net recovery of \$20,000 for the year ended December 31, 2015 and net charge-offs of \$155,000 and \$225,000 for the years ended December 31, 2014 and 2013, respectively. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.18%, 0.17% and 0.17% at December 31, 2015, 2014 and 2013, respectively. Nonaccrual loans totaled \$5.4 million, \$4.5 million and \$6.0 million at December 31, 2015, 2014 and 2013, respectively. To the best of our knowledge, at December 31, 2015, 2014 and 2013, we had provided for all losses that are both probable and reasonable to estimate at those respective dates.

**Noninterest Income.** The following table summarizes changes in noninterest income for the years ended December 31, 2015, 2014 and 2013.

	Year Ended December 31,			Change 2015/2014		Change 2014/2013	
	2015	2014	2013	\$ Change	% Change	\$ Change	% Change
Service fees on loan and deposit accounts	\$ 2,161	\$ 2,022	\$ 2,232	\$ 139	6.9%	\$ (210)	(9.4)%
Income on bank-owned life insurance	1,026	1,060	1,066	(34)	(3.2)%	(6)	(0.6)%
Gain on sale of investment securities	701	1,263	3,450	(562)	(44.5)%	(2,187)	(63.4)%
Gain on sale of loans	503	396	1,541	107	27.0%	(1,145)	(74.3)%
Other	520	436	427	84	19.3%	9	2.1%
<b>Total</b>	<b>\$ 4,911</b>	<b>\$ 5,177</b>	<b>\$ 8,716</b>	<b>\$ (266)</b>	<b>(5.1)%</b>	<b>\$ (3,539)</b>	<b>(40.6)%</b>

Noninterest income declined by \$266,000 for the year ended December 31, 2015 compared to the year ended December 31, 2014. During the years ended December 31, 2015 and 2014, we sold \$7.0 million and \$18.1 million, respectively, of held-to-maturity and trading investment securities and recognized gains of \$701,000 and \$1.3 million, respectively. The sale of held-to-maturity securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investments Debt and Equity Securities 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. During the years ended December 31, 2015 and 2014, we also sold \$56.2 million and \$37.5 million, respectively, of mortgage loans held for sale primarily to reduce interest rate risk and recognized gains of \$503,000 and \$396,000, respectively. Service fees on loan and deposit accounts increased by \$139,000 for the year ended December 31, 2015 compared to the year ended December 31, 2014 primarily due to an increase in broker fee income.



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Noninterest income declined by \$3.5 million for the year ended December 31, 2014 compared to the year ended December 31, 2013. During the years ended December 31, 2014 and 2013, we sold \$18.1 million and \$47.7 million, respectively, of held-to-maturity and trading investment securities and recognized gains of \$1.3 million and \$3.5 million, respectively. The sale of held-to-maturity 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. During the years ended December 31, 2014 and 2013, we also sold \$37.5 million and \$82.2 million, respectively, of mortgage loans held for sale primarily to reduce interest rate risk and recognized gains of \$396,000 and \$1.5 million, respectively.

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**Noninterest Expense.** The following table summarizes changes in noninterest expense for the years ended December 31, 2015, 2014 and 2013.

	Year Ended December 31,			Change 2015/2014		Change 2014/2013	
	2015	2014	2013	\$ Change	% Change	\$ Change	% Change
	(Dollars in thousands)						
Salaries and employee benefits	\$ 21,497	\$ 20,932	\$ 21,015	\$ 565	2.7%	\$ (83)	(0.4)%
Occupancy	5,809	5,761	5,365	48	0.8%	396	7.4%
Equipment	3,894	3,701	3,524	193	5.2%	177	5.0%
Federal deposit insurance premiums	857	808	770	49	6.1%	38	4.9%
Other general and administrative expenses	4,442	4,106	4,403	336	8.2%	(297)	(6.7)%
<b>Total</b>	<b>\$ 36,499</b>	<b>\$ 35,308</b>	<b>\$ 35,077</b>	<b>\$ 1,191</b>	<b>3.4%</b>	<b>\$ 231</b>	<b>0.7%</b>

Noninterest expense rose by \$1.2 million to \$36.5 million for the year ended December 31, 2015 from \$35.3 million for the year ended December 31, 2014. Salaries and employee benefits increased by \$565,000 during the year ended December 31, 2015 primarily due to a bank-wide budgeted salary increase of approximately 3.0%, which was effective July 1, 2015, the hiring of additional staff to originate new loans and to handle the additional workload associated with the increase in regulatory requirements, an increase in employee stock ownership plan expense, which occurred because of the Company's higher stock price, and higher loan officer compensation that occurred primarily because of the increase in new loan originations. Equipment expense grew by \$193,000 due to higher service bureau and data processing expenses. Other general and administrative expenses increased primarily due to higher advertising, professional fees and expenses to originate new mortgage loans.

Noninterest expense rose by \$231,000 to \$35.3 million for the year ended December 31, 2014 from \$35.1 million for the year ended December 31, 2013. Occupancy expense increased by \$396,000 during the year ended December 31, 2014 primarily due to higher depreciation, repair and maintenance costs and rent expense. Equipment expense grew by \$177,000 due to higher depreciation, repairs and maintenance and service bureau expense. The increases in these expenses were partially offset by a \$297,000 decline in other general and administrative expenses due to lower legal costs and a loss on a deposit account recognized during the year ended December 31, 2013.

**Income Tax Expense.** Income taxes were \$9.8 million for 2015, reflecting an effective tax rate of 39.9%, \$8.9 million for 2014, reflecting an effective tax rate of 38.7%, and \$8.8 million for 2013, reflecting an effective tax rate of 37.7%. The effective tax rate in 2015 was higher than the effective tax rate in 2014 primarily due to changes in permanent tax benefits related to compensation and share-based compensation plans. The changes in permanent tax benefits related to compensation and share-based compensation plans also caused the effective tax rate in 2014 to be higher than the effective tax rate for 2013.

### **Nonperforming and Problem Assets**

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When a residential mortgage loan or home equity line of credit is 15 days past due, we attempt personal, direct contact with the borrower to determine when payment will be made. On the first day of the following month, we mail a letter reminding the borrower of the delinquency, and will send an additional letter when a loan is 60 days or more past due. If necessary, subsequent late notices are issued and the account will be monitored on a regular basis thereafter. By the 75<sup>th</sup> day of delinquency, unless the borrower has made arrangements to bring the loan current, we will refer the loan to legal counsel to commence foreclosure proceedings. Upon the recommendation of our Vice President of Mortgage Loan Servicing, the Senior Vice President in charge of the Mortgage Loan Servicing Department can shorten these time frames.

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Commercial business loans, commercial real estate loans and consumer loans are generally handled in the same manner as residential mortgage loans or home equity lines of credit. All commercial business loans that are 15 days past due are immediately referred to our senior lending officer. In addition, we generate past due notices and attempt direct contact with a borrower when a consumer loan is 10 days past due. Because of the nature of the collateral securing consumer loans, we may commence collection procedures earlier for consumer loans than for residential mortgage loans or home equity lines of credit.

Loans are placed on nonaccrual status when payment of principal or interest is more than 90 days contractually delinquent or when, in the opinion of management, collection of principal or interest in full appears doubtful. When loans are placed on a nonaccrual status, unpaid accrued interest is fully reversed. The payments received on nonaccrual loans are recorded as a reduction of principal. The loan may be returned to accrual status if both principal and interest payments are brought current and full payment of principal and interest is expected.

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*Nonperforming Assets.* The table below sets forth the amounts and categories of our nonperforming assets at the dates indicated.



(Dollars in thousands)

Nonaccrual loans:					
Real estate loans:					
First mortgage:					
One- to four-family residential	\$ 5,282	\$ 4,153	\$ 5,840	\$ 4,246	\$ 2,582
Construction, commercial and other					184
Home equity loans and lines of credit	124	296	160	160	158
Other loans	9	4			3
Total nonaccrual loans	5,415	4,453	6,000	4,406	2,927
Real estate owned:					
Real estate loans:					
First mortgage:					
One- to four-family residential					408
Total real estate owned					408
Total nonperforming assets	5,415	4,453	6,000	4,406	3,335
Loans delinquent 90 days or greater and still accruing interest					
Restructured loans still accruing interest:					
Real estate loans:					
First mortgage:					
One- to four-family residential	1,203	2,005	2,533	2,529	2,345
Total restructured loans still accruing interest	1,203	2,005	2,533	2,529	2,345
Total nonperforming assets, accruing loans delinquent for 90 days or more and restructured loans still accruing interest	\$ 6,618	\$ 6,458	\$ 8,533	\$ 6,935	\$ 5,680
Ratios:					
Nonperforming loans to total loans	0.45%	0.46%	0.69%	0.56%	0.42%
Nonperforming assets to total assets	0.30%	0.26%	0.37%	0.28%	0.22%

For the year ended December 31, 2015, gross interest income that would have been recorded had our nonaccruing loans been current in accordance with original terms was \$312,000. For the year ended December 31, 2015, we recognized no interest income on such nonaccruing loans on a cash basis during the year. For the year ended December 31, 2015, gross interest income due and collected on our accruing restructured loans was \$71,000.

The Company had 15 troubled debt restructurings totaling \$3.4 million as of December 31, 2015 that were considered to be impaired. This total included 14 one- to four-family residential mortgage loans totaling \$3.3 million and one home equity loan for \$120,000. Four of the loans, totaling \$885,000, were performing in accordance with their restructured terms and accruing interest at December 31, 2015. Nine of the loans, totaling \$2.0 million, were performing in accordance with their restructured terms but not accruing interest at December 31, 2015. One of the loans, for \$318,000, was 59 days delinquent and accruing interest at December 31, 2015. One of the loans, for \$149,000, was more than 149 days delinquent and not accruing interest as of December 31, 2015. The Company had 17 troubled debt restructurings totaling \$4.6 million as of December 31, 2014 that were considered to be impaired. This total included 16 one- to four-family residential mortgage loans totaling \$4.4 million and one home equity loan for \$135,000. Six of the loans, totaling \$2.0 million, were performing in accordance with their restructured terms and were accruing interest at December 31, 2014. Nine of the loans, totaling \$2.2 million, were performing in accordance with their restructured terms but were not accruing interest at December 31, 2014. Two of the loans, totaling \$343,000, were delinquent and not accruing interest as of December 31, 2014.

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*Delinquent Loans.* The following table sets forth our loan delinquencies by type and by amount at the dates indicated.

	60-89 Days		90 Days and Over		Number	Total			
	Number	Amount	Number	Amount		Number	Amount		
(Dollars in thousands)									
<u>At December 31, 2015</u>									
Real estate loans:									
First mortgage:									
One- to four-family residential		\$	6	\$	1,615	6	\$	1,615	
Home equity loans and lines of credit									
Other loans	3		1		10	4		11	
Total loans	3	\$	1	\$	1,625	10	\$	1,626	
<u>At December 31, 2014</u>									
Real estate loans:									
First mortgage:									
One- to four-family residential	2	\$	736	2	\$	593	4	\$	1,329
Home equity loans and lines of credit				1		161	1		161
Other loans	4		1		4	5		5	
Total loans	6	\$	737	4	\$	758	10	\$	1,495
<u>At December 31, 2013</u>									
Real estate loans:									
First mortgage:									
One- to four-family residential	1	\$	612	5	\$	1,577	6	\$	2,189
Other loans	9		4			9		4	
Total loans	10	\$	616	5	\$	1,577	15	\$	2,193
<u>At December 31, 2012</u>									
Real estate loans:									
First mortgage:									
One- to four-family residential	1	\$	152	8	\$	2,044	9	\$	2,196
Other loans	1		2			1		2	
Total loans	2	\$	154	8	\$	2,044	10	\$	2,198
<u>At December 31, 2011</u>									
Real estate loans:									
First mortgage:									
One- to four-family residential		\$		7	\$	2,148	7	\$	2,148
Construction, commercial and other				1		184	1		184
Other loans				1		3	1		3
Total loans		\$		9	\$	2,335	9	\$	2,335

**Real Estate Owned.** Real estate acquired by us as a result of foreclosure or by deed in lieu of foreclosure is classified as real estate owned. When property is acquired it is recorded at estimated fair value at the date of foreclosure less the cost to sell, establishing a new cost basis. Estimated fair value generally represents the price a buyer would be willing to pay on the basis of current market conditions, including normal terms from other financial institutions. Holding costs and declines in estimated fair value result in charges to expense after acquisition. At December 31, 2015, 2014, 2013 and 2012, we had no real estate owned. At December 31, 2011, we had real estate owned of \$408,000.



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**Classification of Assets.** Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets that are considered to be of lesser quality as substandard, doubtful, or loss assets. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those assets characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets (or portions of assets) classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted. Assets that do not expose us to risk sufficient to warrant classification in one of the aforementioned categories, but which possess potential weaknesses that deserve our close attention, are required to be designated as special mention.

We maintain an allowance for loan losses at an amount estimated to equal all credit losses incurred in our loan portfolio that are both probable and reasonable to estimate at a balance sheet date. Our determination as to the classification of our assets and the amount of our loss allowances is subject to review by our principal federal regulator, the Federal Reserve Board, which can require that we establish additional loss allowances. We regularly review our asset portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of our review of our assets, classified assets totaled \$8.1 million at December 31, 2015, and consisted of substandard assets of \$7.4 million, special mention assets of \$643,000 and no doubtful or loss assets. The classified assets total at December 31, 2015 included \$2.9 million of troubled debt restructurings, \$4.0 million of nonperforming loans and \$1.1 million of trust preferred securities. Effective September 30, 2015, we automatically designate any loan that is 30 to 89 days delinquent as special mention and automatically classify any loan that is delinquent 90 days or more as substandard. Loans which have been delinquent for fewer days may also be classified in these categories.

**Allowance for Loan Losses**

We provide for loan losses based upon the consistent application of our documented allowance for loan loss methodology. All loan losses are charged to the allowance for loan losses and all recoveries are credited to it. Additions to the allowance for loan losses are provided by charges to income based on various factors which, in our judgment, deserve current recognition in estimating probable losses. We regularly review the loan portfolio and make provisions for loan losses in order to maintain the allowance for loan losses in accordance with GAAP.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired in accordance with current accounting standards. The portfolio is grouped into similar risk characteristics, primarily loan type and delinquency status. We apply an estimated loss rate to each loan group. The loss rates applied are based upon our loss experience adjusted, as appropriate, for the environmental factors discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the allowance for loan losses we have established, which could have a material negative effect on our financial results.

Residential mortgage loans represent the largest segment of our loan portfolio. All of the residential mortgage loans are secured by a first mortgage on residential real estate in Hawaii, consist primarily of fixed-rate mortgage loans that have been underwritten to Freddie Mac and Fannie Mae guidelines and have similar risk characteristics. The loan loss allowance is determined by first calculating the historical loss rate for this segment of the portfolio. The loss rate may be adjusted for qualitative and environmental factors. The allowance for loan loss is calculated by multiplying the adjusted loss rate by the total loans in this segment of the portfolio.



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The adjustments to historical loss experience are based on an evaluation of several qualitative and environmental factors, including:

- changes in lending policies and procedures, including changes in underwriting standards and collections, charge-off and recovery practices;
- changes in international, national, and local economic trends;
- changes in the types of loans in the loan portfolio;
- changes in the experience and ability of personnel in the mortgage loan origination and loan servicing departments;
- changes in the number and amount of delinquent loans and classified assets;
- changes in the type and volume of loans being originated;
- changes in the value of underlying collateral for collateral dependent loans;
- changes in any concentration of credit; and
- external factors such as competition, legal and regulatory requirements on the level of estimated credit losses in the existing loan portfolio.

We also use historical loss rates adjusted for qualitative and environmental factors to establish loan loss allowances for the following portfolio segments:

- home equity loans and lines of credit; and

- consumer and other loans.

We have a limited loss experience for the construction, commercial and other mortgage segment of the loan portfolio. The loan loss allowance on this portfolio segment is determined using the loan loss rate of other financial institutions in the State of Hawaii. The allowance for loan loss is calculated by multiplying the loan loss rate of other financial institutions in the state by the total loans in this segment of the loan portfolio.

Generally, when the loan portfolio increases, absent other factors, the allowance for loan loss methodology results in a higher dollar amount of estimated probable losses than would be the case without the increase. Generally, when the loan portfolio decreases, absent other factors, the allowance for loan loss methodology results in a lower dollar amount of estimated probable losses than would be the case without the decrease. The unallocated allowance is established to provide for probable losses that have been incurred as of the reporting date but are not reflected in the allocated allowance.

We evaluate our loan portfolio on a quarterly basis and the allowance is adjusted accordingly. While we use the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, the Federal Reserve Board will periodically review the allowance for loan losses. The Federal Reserve Board may require us to increase the allowance based on their analysis of information available at the time of their examination.

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The following table sets forth activity in our allowance for loan losses for the years indicated.

	At or For the Year Ended December 31,				
	2015	2014	2013	2012	2011
(Dollars in thousands)					
Balance at beginning of year	\$ 1,691	\$ 1,486	\$ 1,672	\$ 1,541	\$ 1,488
Charge-offs:					
Real estate loans:					
First mortgage:					
One- to four-family residential		118	299	333	188
Construction, commercial and other.				8	54
Home equity loans and lines of credit		10	50	3	9
Other loans	53	57	146	48	164
Total charge-offs	53	185	495	392	415
Recoveries:					
Real estate loans:					
First mortgage:					
One- to four-family residential	3	9	235	79	28
Construction, commercial and other.	11	2	12	8	
Home equity loans and lines of credit	47	4	7	5	
Other loans	12	15	16	16	22
Total recoveries	73	30	270	108	50
Net (charge-offs) recoveries	20	(155)	(225)	(284)	(365)
Provision for loan losses	455	360	39	415	418
Balance at end of year	\$ 2,166	\$ 1,691	\$ 1,486	\$ 1,672	\$ 1,541
Ratios:					
Net charge-offs to average loans outstanding	0.00%	0.02%	0.03%	0.04%	0.06%
Allowance for loan losses to nonperforming loans at end of year	40.00%	37.97%	24.77%	37.95%	52.65%
Allowance for loan losses to total loans at end of year	0.18%	0.17%	0.17%	0.22%	0.22%

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**Allocation of Allowance for Loan Losses.** The following tables set forth the allowance for loan losses allocated by loan category and the percent of loans in each category to total loans at the dates indicated. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category. The allowance for loan losses for each category is affected by the national and Hawaii economies and interest rates as well as other factors.

	2015		At December 31, 2014		2013	
	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses (Dollars in thousands)	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans
Real estate loans:						
First mortgage:						
One- to four-family residential	\$ 1,365	95.90%	\$ 410	95.08%	\$ 375	95.41%
Multi-family residential	15	0.82	3	0.92	1	0.57
Construction, commercial and other	517	1.62	977	1.89	799	1.57
Home equity loans and lines of credit	3	1.28	5	1.64	10	1.91
Other loans	72	0.38	263	0.47	229	0.54
Total allocated allowance	1,972	100.00	1,658	100.00	1,414	100.00
Unallocated	194		33		72	
Total	\$ 2,166	100.00%	\$ 1,691	100.00%	\$ 1,486	100.00%

	2012		At December 31, 2011	
	Allowance for Loan Losses	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses (Dollars in thousands)	Percent of Loans in Each Category to Total Loans
Real estate loans:				
First mortgage:				
One- to four-family residential	\$ 585	94.84%	\$ 624	93.90%
Multi-family residential	5	0.88	7	1.00
Construction, commercial and other	818	1.77	285	1.83
Home equity loans and lines of credit	35	1.94	258	2.48
Other loans	107	0.57	291	0.79
Total allocated allowance	1,550	100.00	1,465	100.00
Unallocated	122		76	
Total	\$ 1,672	100.00%	\$ 1,541	100.00%



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In 2015, we revised the qualitative factors that were used to determine the allowance for loan losses. As a result of these modifications, the Company increased the portion of the allowance for loan losses attributable to first mortgage loans and decreased the portion of the allowance for loan losses attributable to construction, commercial and other mortgage loans, and other loans. The allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

**Management of 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.

We continue our efforts to reduce interest rate risk. In 2015, we sold \$56.2 million of fixed-rate mortgage loans and obtained \$37.0 million of additional long-term, fixed-rate borrowings. In 2014, we sold \$37.5 million of fixed-rate mortgage loans. In 2013, we sold \$82.2 million of fixed-rate mortgage loans, obtained \$30.0 million of long-term, fixed-rate borrowings, and purchased \$5.1 million of shorter-duration mortgage-backed securities. In addition, we may utilize the following strategies to further reduce our interest rate risk:

- Continuing our efforts to increase our core checking and passbook accounts, which are less rate-sensitive than certificates of deposit and which provide us with a stable, low-cost source of funds;
  
- Continuing to repay short-term borrowings;
  
- Maintaining overnight cash balances at the Federal Reserve Bank or a portfolio of short-term investments;



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- Purchasing mortgage-backed securities with shorter durations;
- Selling a portion of the fixed-rate mortgage loans we originate to Freddie Mac or Fannie Mae;
- Extending the maturity of our liabilities by obtaining longer-term fixed-rate FHLB advances and securities sold under agreements to repurchase;
- Subject to the maintenance of our credit quality standards, originating commercial loans and home equity lines of credit, which have adjustable interest rates and shorter average lives than first mortgage loans; and
- Maintaining relatively high regulatory capital ratios.

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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. We have no current intention to sell loans classified as held-for-investment.

**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.

The following table presents our internal calculations of the estimated changes in our EVE as of December 31, 2015 that would result from the designated instantaneous changes in the interest rate yield curve.

Change in Interest Rates (bp) (1)	Estimated EVE (2)	Estimated Increase (Decrease) in EVE (Dollars in thousands)	Percentage Change in EVE	EVE Ratio as a Percent of Present Value of Assets (3)(4)	Increase (Decrease) in EVE Ratio as a Percent of Present Value of Assets (3)(4)
+400	\$ 189,762	\$ (55,792)	(22.72)%	10.61%	(2.56)%
+300	\$ 213,175	\$ (32,378)	(13.19)%	11.73%	(1.44)%
+200	\$ 235,831	\$ (9,723)	(3.96)%	12.79%	(0.38)%
+100	\$ 250,952	\$ 5,399	2.20%	13.46%	0.29%
0	\$ 245,554	\$	%	13.17%	%
-100	\$ 211,131	\$ (34,423)	(14.02)%	11.51%	(1.66)%

- (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.

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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.

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**Liquidity and Capital Resources**

Liquidity is the ability to meet current and future financial obligations. Territorial Savings Bank's primary sources of funds consist of deposit inflows, cash balances at the Federal Reserve Bank, loan repayments, advances from the Federal Home Loan Bank, securities sold under agreements to repurchase, proceeds from loan 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 Chief Financial Officer and our Vice President and Controller, which is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs 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 December 31, 2015.

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

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

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

Our most liquid asset is cash. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At December 31, 2015, Territorial Savings Bank's cash and cash equivalents totaled \$65.9 million. On that date, we had \$69.0 million of Federal Home Loan Bank advances outstanding, with the ability to borrow an additional \$555.1 million under Federal Home Loan Bank advances and \$55.0 million in securities sold under agreements to repurchase outstanding.

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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 December 31, 2015, we had \$26.5 million in loan commitments outstanding, most of which were for fixed-rate loans. In addition to commitments to originate loans, we had \$26.6 million in unused lines of credit to borrowers. Certificates of deposit due within one year of December 31, 2015 totaled \$165.0 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 December 31, 2016. 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.

Our primary investing activities are originating loans and purchasing mortgage-backed securities. During the years ended December 31, 2015, 2014 and 2013, we originated \$436.0 million, \$248.0 million and \$306.0 million of loans, respectively. During these years, we purchased \$11.7 million, \$43.9 million and \$270.4 million of securities, respectively.

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Financing activities consist primarily of activity in deposit accounts, Federal Home Loan Bank advances, securities sold under agreements to repurchase, stock repurchases and dividend payments. We experienced net increases in deposits of \$85.4 million and \$71.0 million for the years ended December 31, 2015 and 2014, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the Federal Home Loan Bank, which provide an additional source of funds. We also utilize securities sold under agreements to repurchase as another borrowing source. At December 31, 2015, we had the ability to borrow up to an additional \$555.1 million from the Federal Home Loan Bank. Advances from the Federal Home Loan Bank increased by \$54.0 million while securities sold under agreements to repurchase decreased by \$17.0 million for the year ended December 31, 2015.

As a separate legal entity, Territorial Bancorp Inc. is required to have liquidity to fund stock repurchases and dividend payments to shareholders and for other corporate purposes. In 2014, 2013, 2011 and 2010, Territorial Bancorp Inc. adopted common stock repurchase programs. Shares repurchased will reduce the amount of shares issued and outstanding. The repurchased shares may be reissued in connection with share-based compensation plans and for general corporate purposes. During the years ended December 31, 2015 and 2014, the Company repurchased 373,711 and 221,530 shares, respectively, of the total 3,099,253 shares authorized by the Board of Directors. For the years ended December 31, 2015 and 2014, the shares were repurchased at an average cost of \$23.91 and \$22.48, respectively. At December 31, 2015 and 2014, on a stand-alone basis, Territorial Bancorp Inc. had liquid assets of \$15.8 million and \$16.2 million, respectively.

Territorial Savings Bank and the Company are subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At December 31, 2015, Territorial Savings Bank and the Company exceeded all regulatory capital requirements and are considered to be well capitalized under regulatory guidelines. See Note 23 of the Notes to the Consolidated Financial Statements.

The net proceeds from the stock offering significantly increased our liquidity and capital resources. Over time, the initial level of liquidity will be reduced as net proceeds from the stock offering are used for general corporate purposes, including the funding of loans. Our financial condition and results of operations were enhanced by the net proceeds from the stock offering, resulting in increased net interest-earning assets and net interest income. However, due to the increase in equity resulting from the net proceeds raised in the stock offering, our return on equity has been adversely affected following the stock offering.

**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. For additional information, see Note 22 of the Notes to the Consolidated Financial Statements.

*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.

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The following table summarizes our significant fixed and determinable contractual obligations and other funding needs by payment date at December 31, 2015. The payment amounts represent those amounts due to the recipient and do not include any unamortized premiums or discounts or other similar carrying amount adjustments.

Contractual Obligations	Payments Due by Period				Total
	One Year or Less	More Than One Year to Three Years	More Than Three Years to Five Years (In thousands)	More Than Five Years	
Long-term debt	\$	\$ 62,000	\$ 62,000	\$	\$ 124,000
Operating leases	2,677	4,202	2,207	844	9,930
Capitalized leases					
Purchase obligations	2,182	2,213	10		4,405
Certificates of deposit	165,007	22,820	36,208		224,035
Other long-term liabilities					
<b>Total</b>	<b>\$ 169,866</b>	<b>\$ 91,235</b>	<b>\$ 100,425</b>	<b>\$ 844</b>	<b>\$ 362,370</b>
Commitments to extend credit	\$ 27,459	\$	\$	\$	\$ 27,459

### **Recent Accounting Pronouncements**

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

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

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

In August 2014, the FASB amended the Receivables topic of the FASB ASC. The amendment seeks to clarify the classification of foreclosed mortgage loans that are either fully or partially guaranteed under government programs, such as from the Federal Housing Administration (FHA) or the U.S. Department of Veterans Affairs (VA). The amendment was effective for interim and annual periods beginning after December 15,



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2014. The Company adopted this amendment on January 1, 2015, and the adoption did not have any effect on its consolidated financial statements.

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

In January 2016, the FASB amended the Financial Instruments – Overall topic of the FASB ASC. The amendment addresses several aspects of recognition, measurement, presentation and disclosure of financial instruments. Included are: (a) a requirement to measure equity investments at fair value, with changes in fair value recognized in net income, (b) a simplification of the impairment assessment of equity investments without readily determinable fair values, (c) the elimination of the requirement to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet, and (d) a requirement to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this amendment to have a material effect on its consolidated financial statements.

In February 2016, the FASB amended the Leases topic of the FASB ASC. The primary effects of the amendment will be to recognize lease assets and lease liabilities on the balance sheet and to disclose certain information about leasing arrangements. The amendment is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the effects that the adoption of this amendment will have on its consolidated financial statements.

**Impact of Inflation and Changing Prices**

Our consolidated financial statements and related notes have been prepared in accordance with U.S. GAAP. U.S. GAAP generally requires the measurement of financial position and operating results in terms of historical dollars without consideration of changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial companies, our assets and liabilities are primarily monetary in nature. As a result, changes in market interest rates have a greater impact on performance than the effects of inflation.

**ITEM 7A. Quantitative and Qualitative Disclosures About Market Risk**

Information required by this item is included in ITEM 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, above.

**ITEM 8. Financial Statements and Supplementary Data**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders

Territorial Bancorp, Inc.

We have audited the accompanying consolidated balance sheets of Territorial Bancorp Inc. and subsidiaries (the Company) as of December 31, 2015, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the year ended December 31, 2015. We also have audited the Company's internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Territorial Bancorp Inc. as of December 31, 2015, and the consolidated results of their operations and their cash flows for the year ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Territorial Bancorp Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015 based on

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criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ Moss Adams LLP

Portland, Oregon

March 14, 2016

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Territorial Bancorp Inc.:

We have audited the accompanying consolidated balance sheet of Territorial Bancorp Inc. and subsidiaries as of December 31, 2014, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2014. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Territorial Bancorp Inc. and subsidiaries as of December 31, 2014, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Honolulu, Hawaii  
March 13, 2015

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## TERRITORIAL BANCORP INC. AND SUBSIDIARIES

**Consolidated Balance Sheets****December 31, 2015 and 2014****(Dollars in thousands, except share data)**

	2015	2014
<b>ASSETS</b>		
Cash and cash equivalents	\$ 65,919	\$ 75,060
Investment securities held to maturity, at amortized cost (fair value of \$497,982 and \$586,710 at December 31, 2015 and 2014, respectively)	493,059	572,922
Loans held for sale	2,139	1,048
Loans receivable, net	1,188,649	968,212
Federal Home Loan Bank stock, at cost	4,790	11,234
Federal Reserve Bank stock, at cost	3,022	2,925
Accrued interest receivable	4,684	4,436
Premises and equipment, net	4,903	5,629
Bank-owned life insurance	42,328	41,303
Deferred income tax assets, net	9,378	7,254
Prepaid expenses and other assets	2,270	1,874
Total assets	\$ 1,821,141	\$ 1,691,897
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Liabilities:		
Deposits	\$ 1,445,103	\$ 1,359,679
Advances from the Federal Home Loan Bank	69,000	15,000
Securities sold under agreements to repurchase	55,000	72,000
Accounts payable and accrued expenses	25,178	24,098
Current income taxes payable	2,095	826
Advance payments by borrowers for taxes and insurance	5,124	3,916
Total liabilities	1,601,500	1,475,519
Stockholders Equity:		
Preferred stock, \$.01 par value; authorized 50,000,000 shares, no shares issued or outstanding		
Common stock, \$.01 par value; authorized 100,000,000 shares; issued and outstanding 9,659,685 and 9,919,064 shares at December 31, 2015 and 2014, respectively	96	99
Additional paid-in capital	70,118	75,229
Unearned ESOP shares	(6,361)	(6,851)
Retained earnings	161,024	153,289
Accumulated other comprehensive loss	(5,236)	(5,388)
Total stockholders equity	219,641	216,378
Total liabilities and stockholders equity	\$ 1,821,141	\$ 1,691,897

See accompanying notes to consolidated financial statements.



Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Income****For the years ended December 31, 2015, 2014 and 2013****(Dollars in thousands, except per share data)**

	2015	2014	2013
<b>Interest and dividend income:</b>			
Loans	\$ 45,903	\$ 39,620	\$ 36,982
Investment securities	16,873	19,752	18,941
Other investments	316	243	252
Total interest and dividend income	63,092	59,615	56,175
<b>Interest expense:</b>			
Deposits	4,821	4,474	4,296
Advances from the Federal Home Loan Bank	697	266	302
Securities sold under agreements to repurchase	997	1,378	1,684
Total interest expense	6,515	6,118	6,282
Net interest income	56,577	53,497	49,893
Provision for loan losses	455	360	39
Net interest income after provision for loan losses	56,122	53,137	49,854
<b>Noninterest income:</b>			
Service fees on loan and deposit accounts	2,161	2,022	2,232
Income on bank-owned life insurance	1,026	1,060	1,066
Gain on sale of investment securities	701	1,263	3,450
Gain on sale of loans	503	396	1,541
Other	520	436	427
Total noninterest income	4,911	5,177	8,716
<b>Noninterest expense:</b>			
Salaries and employee benefits	21,497	20,932	21,015
Occupancy	5,809	5,761	5,365
Equipment	3,894	3,701	3,524
Federal deposit insurance premiums	857	808	770
Other general and administrative expenses	4,442	4,106	4,403
Total noninterest expense	36,499	35,308	35,077
Income before income taxes	24,534	23,006	23,493
Income taxes	9,786	8,909	8,846
Net income	\$ 14,748	\$ 14,097	\$ 14,647
Basic earnings per share	\$ 1.63	\$ 1.53	\$ 1.51
Diluted earnings per share	\$ 1.59	\$ 1.51	\$ 1.49
Cash dividends declared per common share	\$ 0.76	\$ 0.70	\$ 0.62
Basic weighted-average shares outstanding	9,073,015	9,211,409	9,711,233
Diluted weighted-average shares outstanding	9,263,267	9,317,323	9,844,942

See accompanying notes to consolidated financial statements.





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**TERRITORIAL BANCORP INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income  
For the years ended December 31, 2015, 2014 and 2013**

(Dollars in thousands)

	2015		2014		2013
Net income	\$ 14,748	\$	14,097	\$	14,647
Change in unfunded pension liability	(12)		(1,694)		454
Change in unrealized loss on securities	137		1		23
Change in noncredit related loss on trust preferred securities	27		92		69
Other comprehensive income (loss), net of tax	152		(1,601)		546
Comprehensive income	\$ 14,900	\$	12,496	\$	15,193

See accompanying notes to consolidated financial statements.

Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Stockholders' Equity**

**For the years ended December 31, 2015, 2014 and 2013**  
**(Dollars in thousands, except share data)**

	<b>Common Stock</b>	<b>Additional Paid-in Capital</b>	<b>Unearned ESOP Shares</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total Stockholders Equity</b>
Balances at December 31, 2012	\$ 108	\$ 93,616	\$ (7,829)	\$ 137,410	\$ (4,333)	\$ 218,972
Net income				14,647		14,647
Other comprehensive income					546	546
Cash dividends declared (\$0.62 per share)				(6,231)		(6,231)
Share-based compensation	1	2,675				2,676
Allocation of 48,932 ESOP shares		636	489			1,125
Repurchase of 868,203 shares of company common stock	(8)	(19,587)				(19,595)
Balances at December 31, 2013	\$ 101	\$ 77,340	\$ (7,340)	\$ 145,826	\$ (3,787)	\$ 212,140
Net income				14,097		14,097
Other comprehensive loss					(1,601)	(1,601)
Cash dividends declared (\$0.70 per share)				(6,634)		(6,634)
Share-based compensation	1	2,816				2,817
Allocation of 48,932 ESOP shares		547	489			1,036
Repurchase of 245,645 shares of company common stock	(3)	(5,474)				(5,477)
Balances at December 31, 2014	\$ 99	\$ 75,229	\$ (6,851)	\$ 153,289	\$ (5,388)	\$ 216,378
Net income				14,748		14,748
Other comprehensive income					152	152
Cash dividends declared (\$0.76 per share)				(7,013)		(7,013)
Share-based compensation	1	3,085				3,086
Allocation of 48,932 ESOP shares		720	490			1,210
Repurchase of 373,711 shares of company common stock	(4)	(8,933)				(8,937)
Exercise of 1,000 options of common stock		17				17
Balances at December 31, 2015	\$ 96	\$ 70,118	\$ (6,361)	\$ 161,024	\$ (5,236)	\$ 219,641

See accompanying notes to consolidated financial statements.

Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows****For the years ended December 31, 2015, 2014 and 2013****(Dollars in thousands)**

	2015	2014	2013
<b>Cash flows from operating activities:</b>			
Net income	\$ 14,748	\$ 14,097	\$ 14,647
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	455	360	39
Depreciation and amortization	1,296	1,389	1,138
Deferred income tax benefit	(2,223)	(1,122)	(1,856)
Amortization of fees, discounts, and premiums	(492)	(441)	249
Origination of loans held for sale	(57,337)	(36,146)	(81,654)
Proceeds from sales of loans held for sale	56,493	37,704	83,205
Gain on sale of loans, net	(503)	(396)	(1,541)
Provision for real estate owned losses			14
Net gain on sale of real estate owned	(12)		(1)
Purchases of investment securities held for trading		(5,041)	
Proceeds from sale of investment securities held for trading		5,071	
Gain on sale of investment securities held for trading		(30)	
Gain on sale of investment securities held to maturity	(701)	(1,233)	(3,450)
Net loss on sale of premises and equipment	4	4	
ESOP expense	1,210	1,036	1,125
Share-based compensation expense	3,086	2,817	2,676
(Increase) decrease in accrued interest receivable	(248)	(126)	57
Net increase in bank-owned life insurance	(1,025)	(1,060)	(1,066)
Net (increase) decrease in prepaid expenses and other assets	(366)	104	1,754
Net increase (decrease) in accounts payable and accrued expenses	249	(2,513)	1,669
Net increase in advance payments by borrowers for taxes and insurance	1,208	208	69
Net increase (decrease) in income taxes payable	1,269	(588)	262
<b>Net cash from operating activities</b>	<b>17,111</b>	<b>14,094</b>	<b>17,336</b>
<b>Cash flows from investing activities:</b>			
Purchases of investment securities held to maturity	(11,606)	(38,826)	(270,406)
Principal repayments on investment securities held to maturity	85,802	66,317	162,800
Proceeds from sale of investment securities held to maturity	7,718	14,248	51,102
Loan originations, net of principal repayments on loans receivable	(220,215)	(111,426)	(80,752)
Purchases of FHLB stock	(3,120)		
Proceeds from redemption of FHLB stock	9,564	455	439
Purchases of Federal Reserve Bank stock	(97)	(2,925)	
Purchases of bank-owned life insurance			(8,000)
Proceeds from sale of real estate owned	204		130
Purchases of premises and equipment	(604)	(973)	(2,138)
Proceeds from disposals of premises and equipment		7	
<b>Net cash from investing activities</b>	<b>(132,354)</b>	<b>(73,123)</b>	<b>(146,825)</b>

*(Continued)*



Table of Contents**TERRITORIAL BANCORP INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows****For the years ended December 31, 2015, 2014 and 2013****(Dollars in thousands)**

	2015	2014	2013
<b>Cash flows from financing activities:</b>			
Net increase in deposits	\$ 85,424	\$ 70,970	\$ 50,862
Proceeds from advances from the Federal Home Loan Bank	120,000		5,000
Repayments of advances from the Federal Home Loan Bank	(66,000)		(10,000)
Proceeds from securities sold under agreements to repurchase	30,000		25,000
Repayments of securities sold under agreements to repurchase	(47,000)		(23,000)
Purchases of Fed Funds	10	10	
Sales of Fed Funds	(10)	(10)	
Proceeds from exercise of stock options	17		
Repurchases of common stock	(9,326)	(5,612)	(19,595)
Cash dividends paid	(7,013)	(6,634)	(6,231)
<b>Net cash from financing activities</b>	<b>106,102</b>	<b>58,724</b>	<b>22,036</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(9,141)</b>	<b>(305)</b>	<b>(107,453)</b>
Cash and cash equivalents at beginning of the year	75,060	75,365	182,818
Cash and cash equivalents at end of the year	\$ 65,919	\$ 75,060	\$ 75,365
<b>Supplemental disclosure of cash flow information:</b>			
<b>Cash paid for:</b>			
Interest on deposits and borrowings	\$ 6,648	\$ 6,055	\$ 6,232
Income taxes	10,324	10,478	10,440
<b>Supplemental disclosure of noncash investing and financing activities:</b>			
Loans transferred to real estate owned	\$ 192	\$	143
Investments purchased, not settled	1,200		
Company stock repurchased prior year, settled current year	389		

See accompanying notes to consolidated financial statements.

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**(1) Organization**

On November 4, 2008, the Board of Directors of Territorial Mutual Holding Company (MHC) approved a plan of conversion and reorganization under which MHC would convert from a mutual holding company to a stock holding company. The conversion to a stock holding company was approved by the depositors and borrowers of Territorial Savings Bank and the Office of Thrift Supervision (OTS) and included the filing of a registration statement with the U.S. Securities and Exchange Commission. Upon the completion of the conversion and reorganization on July 10, 2009, Territorial Mutual Holding Company and Territorial Savings Group, Inc. ceased to exist as separate legal entities and Territorial Bancorp Inc. became the holding company for Territorial Savings Bank. A total of 12,233,125 shares were issued in the conversion at \$10 per share. 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. The balance of the liquidation account at December 31, 2015 was \$13.5 million.

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

**(2) Summary of Significant Accounting Policies**

**(a) *Description of Business***

Territorial Bancorp Inc. (the Company), through its wholly-owned subsidiary, Territorial Savings Bank (the Bank), provides loan and deposit products and services primarily to individual customers through 28 branches located throughout Hawaii. We deal primarily in residential mortgage loans in the State of Hawaii. The Company's earnings depend primarily on its net interest income, which is the difference between the interest income earned on interest-earning assets (loans receivable and investments) and the interest expense incurred on interest-bearing liabilities (deposit liabilities and borrowings). Deposits traditionally have been the principal source of the Bank's funds for use in lending, meeting liquidity requirements, and making investments. The Company also derives funds from receipt of interest and principal on outstanding loans receivable and investments, borrowings from the Federal Home Loan Bank (FHLB), securities sold under agreements to repurchase, and proceeds from issuance of common stock.

**(b) *Principles of Consolidation***

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The consolidated financial statements include the accounts and results of operations of Territorial Bancorp Inc. and Territorial Savings Bank and its wholly-owned subsidiaries, Territorial Real Estate Co., Inc. and Territorial Financial Services, Inc. Significant intercompany balances and transactions have been eliminated in consolidation.



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(c) ***Cash and Cash Equivalents***

Cash and cash equivalents includes cash and due from banks, interest-bearing deposits in other banks, federal funds sold, and short-term, highly liquid investments with original maturities of three months or less.

(d) ***Investment Securities***

The Company classifies and accounts for its investment securities as follows: (1) held-to-maturity debt securities in which the Company has the positive intent and ability to hold to maturity are reported at amortized cost; (2) trading securities that are purchased for the purpose of selling in the near term are reported at fair value, with unrealized gains and losses included in current earnings; and (3) available-for-sale securities not classified as either held-to-maturity or trading securities are reported at fair value, with unrealized gains and losses excluded from current earnings and reported as a separate component of equity. At December 31, 2015 and 2014, the Company classified all of its investments as held-to-maturity.

A decline in the market value of any available-for-sale or held-to-maturity security below cost, that is deemed to be other than temporary, results in an impairment to reduce the carrying amount to fair value. To determine whether impairment is other than temporary, the Company considers whether it has the intent and ability not to sell and would not be required to sell for a sufficient period of time to recover the remaining amortized cost basis.

Gains or losses on the sale of investment securities are computed using the specific-identification method. The Company amortizes premiums and accretes discounts associated with investment securities using the interest method over the contractual life of the respective investment security. Such amortization and accretion is included in the interest and dividend income line item in the consolidated statements of income. Dividend and interest income are recognized when earned.

(e) ***Loans Receivable***

This policy applies to all loan classes. Loans receivable are stated at the principal amount outstanding, less the allowance for loan losses, loan origination fees and costs, and commitment fees. Interest on loans receivable is accrued as earned. The Company has a policy of placing loans on a nonaccrual basis when 90 days or more contractually delinquent or when, in the opinion of management, collection of all or part of the principal balance appears doubtful. For nonaccrual loans, the Company records payments received as a reduction in principal. The Company, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, if the loan is considered to be collateral dependent, based on the fair value of the collateral less estimated costs to sell. Impairment losses are written off against the allowance for loan losses. For nonaccrual impaired loans, the Company records payments received as a reduction in principal. A nonaccrual loan may be restored to an accrual basis when principal and interest payments are current and full payment of principal and interest is expected.

(f) *Loans Held for Sale*

Loans held for sale are stated at the lower of aggregate cost or market value. Net fees and costs of originating loans held for sale are deferred and are included in the basis for determining the gain or loss on sales of loans held for sale.

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(g) ***Deferred Loan Origination Fees and Unearned Loan Discounts***

Loan origination and commitment fees and certain direct loan origination costs are being deferred, and the net amount is recognized over the life of the related loan as an adjustment to yield. Net deferred loan fees are amortized using the interest method over the contractual term of the loan, adjusted for actual prepayments. Net unamortized fees on loans paid in full are recognized as a component of interest income.

(h) ***Real Estate Owned***

Real estate owned is valued at the time of foreclosure at fair value, less estimated cost to sell, thereby establishing a new cost basis. The Company obtains appraisals based on recent comparable sales to assist management in estimating the fair value of real estate owned. Subsequent to acquisition, real estate owned is valued at the lower of cost or fair value, less estimated cost to sell. Declines in value are charged to expense through a direct write-down of the asset. Costs related to holding real estate are charged to expense while costs related to development and improvements are capitalized.

Gains from the sale of real estate owned, if any, are recognized when title has passed, minimum down payment requirements are met, the terms of any notes received are such as to satisfy continuing investment requirements, and the Company is relieved of any requirements for continued involvement with the properties. If the minimum down payment or the continuing investment is not adequate to meet the criteria specified in the Property, Plant and Equipment topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC), the Company will defer income recognition and account for such sales using alternative methods, such as installment, deposit, or cost recovery.

(i) ***Allowance for Loan Losses***

The Company maintains an allowance adequate to cover Management's estimate of probable loan losses as of the balance sheet date. The Company's allowance for loan losses is maintained at a level considered adequate to provide for losses that can be estimated based upon specific and general conditions. All loan losses are charged, and all recoveries are credited, to the allowance for loan losses. Additions to the allowance for loan losses are provided by charges to income based on various factors, which, in the Company's judgment, deserve current recognition in estimating probable losses. Charge-offs to the allowance are made when management determines that collectability of all or a portion of a loan is doubtful and available collateral is insufficient to repay the loan.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired, in accordance with the Receivables topic of the FASB ASC. The portfolio is grouped into similar risk characteristics, primarily loan type and delinquency status. The Company applies an estimated loss rate to each loan group. The loss rates applied are based upon its loss experience adjusted, as appropriate, for environmental factors discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the allowance for loan losses the Company has established, which could have a material negative effect on its financial results.

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Residential mortgage loans represent the largest segment of the Company's loan portfolio. All of the residential mortgage loans are secured by a first mortgage on residential real estate in Hawaii and consist primarily of fixed-rate mortgage loans which have been underwritten to Freddie Mac and Fannie Mae guidelines and have similar risk characteristics. The loan loss allowance is determined by first calculating the historical loss rate for this segment of the portfolio. The loss rate may be adjusted for qualitative and environmental factors. The allowance for loan loss is calculated by multiplying the adjusted loss rate by the total loans in this segment of the portfolio.

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The adjustments to historical loss experience are based on an evaluation of several qualitative and environmental factors, including:

- changes in lending policies and procedures, including changes in underwriting standards and collections, charge-off and recovery practices;
  
- changes in international, national, and local economic trends;
  
- changes in the types of loans in the loan portfolio;
  
- changes in the experience and ability of personnel in the mortgage loan origination and loan servicing departments;
  
- changes in the number and amount of delinquent loans and classified assets;
  
- changes in the type and volume of loans being originated;
  
- changes in the value of underlying collateral for collateral dependent loans;
  
- changes in any concentration 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 uses historical loss rates adjusted for qualitative and environmental factors to establish loan loss allowances for the following portfolio segments:

- home equity loans and lines of credit; and

- consumer and other loans.

The Company has a limited loss experience for the construction, commercial and other mortgage segment of the loan portfolio. The loan loss allowance on this portfolio segment is determined using the loan loss rate of other financial institutions in the State of Hawaii. The allowance for loan loss is calculated by multiplying the loan loss rate of other financial institutions in the state by the total loans in this segment of the Company's loan portfolio.

The allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. In addition, the unallocated allowance is established to provide for probable losses that have been incurred as of the reporting date but are not reflected in the allocated allowance.

While the Company uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, the Federal Reserve Board will periodically review the allowance for loan losses. The Federal Reserve Board 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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(j) ***Transfer of Financial Assets***

Transfers of financial assets are accounted for as sales when control is surrendered. Control is surrendered when the assets have been isolated from the Company, the transferee obtains the right to pledge or exchange the assets without constraint, and the Company does not maintain effective control over the transferred assets. Mortgage loans sold for cash are accounted for as sales as the above criteria have been met.

Mortgage loans may also be packaged into securities that are issued and guaranteed by U.S. government-sponsored enterprises or a U.S. government agency. The Company receives 100% of the mortgage-backed securities issued. Securitizations are not accounted for as sales and no gain or loss is recognized. The mortgage-backed securities received in securitizations are valued at amortized cost and classified as held-to-maturity.

Mortgage loan transfers accounted for as sales and securitizations are without recourse, except for normal representations and warranties provided in sales transactions, and the Company may retain the related rights to service the loans. The retained servicing rights create mortgage servicing assets that are accounted for in accordance with the Transfers and Servicing topic of the FASB ASC. Mortgage servicing assets are initially valued at fair value and subsequently at the lower of cost or fair value and are amortized in proportion to and over the period of estimated net servicing income. The Company uses a discounted cash flow model to determine the fair value of retained mortgage servicing rights. Prior to 2010, we retained the servicing rights on residential mortgage loans sold. In 2010, we began selling loans primarily on a servicing-released basis.

(k) ***Premises and Equipment***

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is principally computed on the straight-line method over the estimated useful lives of the respective assets. The estimated useful life of buildings and improvements is 30 years, furniture, fixtures, and equipment is 3 to 10 years, and automobiles are 3 years. Leasehold improvements are amortized on a straight-line basis over the shorter of the lease term or estimated useful life of the asset.

(l) ***Income Taxes***

The Company files consolidated federal income tax and consolidated state franchise tax returns.

Deferred tax assets and liabilities are recognized using the asset and liability method of accounting for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and net operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

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We establish income tax contingency reserves for potential tax liabilities related to uncertain tax positions. A liability for income tax uncertainties would be recorded for unrecognized tax benefits related to uncertain tax positions where it is more likely than not that the position will be sustained upon examination by a taxing authority.

As of December 31, 2015 and 2014, the Company had not recognized a liability for income tax uncertainties in the accompanying consolidated balance sheets because Management concluded that the Company does not have uncertain tax positions.



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The Company recognizes interest and penalties related to tax liabilities in other interest expense and other general and administrative expenses, respectively, in the consolidated statements of income.

Tax years 2012 to 2014 currently remain subject to examination by the Internal Revenue Service and by the Department of Taxation of the State of Hawaii.

*(m) Impairment of Long-Lived Assets*

Long-lived assets, such as premises and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the consolidated balance sheets and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

*(n) Pension Plan*

Pension benefit costs (returns) are charged (credited) to salaries and employee benefits expense, and the corresponding prepaid (accrued) pension cost is recorded in prepaid expenses and other assets or accounts payable and accrued expenses in the consolidated balance sheets. The Company's policy is to fund pension costs in amounts that will not be less than the minimum funding requirements of the Employee Retirement Income Security Act of 1974 and will not exceed the maximum tax-deductible amounts. The Company generally funds at least the net periodic pension cost, subject to limits and targeted funded status as determined with the consulting actuary.

*(o) Employee Stock Ownership Plan (ESOP)*

The cost of shares issued to the ESOP, but not yet allocated to participants, is shown as a reduction of stockholders' equity. Compensation expense is based on the market price of shares as they are committed to be released to participant accounts. Dividends on allocated ESOP shares reduce retained earnings; dividends on unearned ESOP shares reduce debt and accrued interest.

*(p) Earnings Per Share*

Basic earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the sum of the weighted-average number of shares outstanding plus the dilutive effect of stock options and restricted stock. ESOP shares not committed to be released are not considered outstanding.

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

*(q) Common Stock Repurchase Program*

In 2014, 2013, 2011 and 2010, the Company adopted common stock repurchase programs in which shares repurchased reduce the amount of shares issued and outstanding. The repurchased shares may be reissued in connection with share-based compensation plans and for general corporate purposes. As of December 31, 2015 and 2014, the Company had accumulated repurchases of 3,099,253 and 2,749,789 shares, respectively, of the total 3,099,253 shares authorized by the Board of Directors. During 2015 and 2014, shares were repurchased at an average cost of \$23.91 and \$22.48, respectively.

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(r) ***Bank-Owned Life Insurance***

The Company's investment in bank-owned life insurance is based on cash surrender value. The Company invests in bank-owned life insurance to provide a funding source for benefit plan obligations. Bank-owned life insurance also generally provides noninterest income that is nontaxable. Federal regulations generally limit the investment in bank-owned life insurance to 25% of the Bank's Tier 1 capital plus the allowance for loan losses. At December 31, 2015, this limit was \$52.6 million and the Company had invested \$42.3 million in bank-owned life insurance at that date.

(s) ***Use of Estimates***

The preparation of the consolidated financial statements requires management to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amount of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the allowance for loan losses; valuation of certain investment securities and determination as to whether declines in fair value below amortized cost are other than temporary; valuation allowances for deferred income tax assets; mortgage servicing assets; and assets and obligations related to employee benefit plans. Accordingly, actual results could differ from those estimates.

(t) ***Recently Issued Accounting Pronouncements***

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

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

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



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

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

In January 2016, the FASB amended the Financial Instruments – Overall topic of the FASB ASC. The amendment addresses several aspects of recognition, measurement, presentation and disclosure of financial instruments. Included are: (a) a requirement to measure equity investments at fair value, with changes in fair value recognized in net income, (b) a simplification of the impairment assessment of equity investments without readily determinable fair values, (c) the elimination of the requirement to disclose the methods and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet, and (d) a requirement to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this amendment to have a material effect on its consolidated financial statements.

In February 2016, the FASB amended the Leases topic of the FASB ASC. The primary effects of the amendment will be to recognize lease assets and lease liabilities on the balance sheet and to disclose certain information about leasing arrangements. The amendment is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the effects that the adoption of this amendment will have on its consolidated financial statements.

**(3) Cash and Cash Equivalents**

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

(Dollars in thousands)	December 31,	
	2015	2014
Cash and due from banks	\$ 10,318	\$ 10,803
Interest-earning deposits in other banks	55,601	64,257
Cash and cash equivalents	\$ 65,919	\$ 75,060

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



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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Losses	Estimated Fair Value
December 31, 2015:				
Held to maturity:				
U.S. government-sponsored mortgage-backed securities	\$ 492,143	\$ 11,092	\$ (6,169)	\$ 497,066
Trust preferred securities	916			916
<b>Total</b>	<b>\$ 493,059</b>	<b>\$ 11,092</b>	<b>\$ (6,169)</b>	<b>\$ 497,982</b>
December 31, 2014:				
Held to maturity:				
U.S. government-sponsored mortgage-backed securities	\$ 572,232	\$ 18,078	\$ (4,290)	\$ 586,020
Trust preferred securities	690			690
<b>Total</b>	<b>\$ 572,922</b>	<b>\$ 18,078</b>	<b>\$ (4,290)</b>	<b>\$ 586,710</b>

The amortized cost and estimated fair value of investment securities at December 31, 2015 are shown below. Incorporated in the maturity schedule are mortgage-backed and trust preferred securities, which are allocated using the contractual maturity as a basis. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Estimated Fair Value
Held to maturity:		
Due within 5 years	\$ 32	\$ 34
Due after 5 years through 10 years	7	7
Due after 10 years	493,020	497,941
<b>Total</b>	<b>\$ 493,059</b>	<b>\$ 497,982</b>

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

(Dollars in thousands)	2015	2014	2013
Proceeds from sales	\$ 7,719	\$ 19,319	\$ 51,102
Gross gains	701	1,263	3,450
Gross losses			

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In 2015, the Company received proceeds of \$7.7 million from the sale of \$7.0 million of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$639,000. In 2014, the Company received proceeds of \$14.2 million from the sale of \$13.0 million of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$1.2 million. In 2013, the Company received proceeds of \$51.1 million from the sale of \$47.7 million of held-to-maturity mortgage-backed securities, resulting in gross realized gains of \$3.5 million. The sale of these mortgage-backed securities, for which the Company had already collected a substantial portion of the outstanding purchased principal (at least 85%), is in accordance with the Investments Debt and Equity Securities topic of the FASB ASC and does not taint management's assertion of intent to hold remaining securities in the held-to-maturity portfolios to maturity.

Investment securities with amortized costs of \$241.4 million and \$270.2 million at December 31, 2015 and 2014, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase and transaction clearing accounts.

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

Description of securities (Dollars in thousands)	Less Than 12 Months		12 Months or Longer		Number of Securities	Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		Fair Value	Unrealized Losses
<b>December 31, 2015:</b>							
Mortgage-backed securities	\$ 142,810	\$ 3,939	\$ 53,142	\$ 2,230	43	\$ 195,952	\$ 6,169
<b>December 31, 2014:</b>							
Mortgage-backed securities	\$ 12,717	\$ 65	\$ 183,349	\$ 4,225	37	\$ 196,066	\$ 4,290

**Mortgage-Backed Securities.** The unrealized losses on the Company's investment in mortgage-backed securities were caused by increases in market interest rates. All of the mortgage-backed securities are guaranteed by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. Since the decline in market value is attributable to changes in interest rates and not credit quality, the Company does not intend to sell these investments until maturity and it is not more likely than not that the Company will be required to sell such investments prior to recovery of its cost basis, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2015 and 2014.

**Trust Preferred Securities.** At December 31, 2015, the Company owned one trust preferred security, PreTSL XXIII. The trust preferred security represents an investment in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. This security is classified in the Company's held-to-maturity investment portfolio.

The trust preferred securities market is considered to be inactive as only six transactions have occurred over the past 48 months in the same tranche of securities owned by the Company. The Company uses a discounted cash flow model to determine whether this security is



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other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows.

Based on the Company's review, the Company's investment in PreTSL XXIII did not incur additional impairment during the years ended December 31, 2015, 2014 and 2013.

PreTSL XXIII has an amortized cost of \$916,000 at December 31, 2015. The difference between the amortized cost of \$916,000 and the remaining cost basis of \$1.1 million is reported as accumulated other comprehensive loss and is related to noncredit factors.

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

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

(Dollars in thousands)	2015		2014	
Balance at January 1,	\$	5,885	\$	5,885
Credit losses on debt securities for which other-than-temporary impairment was not previously recognized				
Credit losses on debt securities which were sold		(3,482)		
Balance at December 31,	\$	2,403	\$	5,885

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

(Dollars in thousands)	December 31,	
	2015	2014
Noncredit losses on other-than-temporarily impaired securities, net of taxes	\$ 147	\$ 283

### (5) Federal Home Loan Bank Stock

The Bank, as a member of the FHLB system, is required to obtain and hold shares of capital stock in the FHLB. At December 31, 2015 and 2014, the Bank met such requirement. At December 31, 2015 and 2014, the Bank owned \$4.8 million and \$11.2 million, respectively, of capital stock of the FHLB.

On June 1, 2015, the Federal Home Loan Bank of Seattle (FHLB Seattle) completed its merger with the Federal Home Loan Bank of Des Moines (FHLB Des Moines). After the merger, the FHLB Des Moines repurchased all outstanding excess capital stock, resulting in the repurchase of \$7.2 million of capital stock we held in the FHLB Des Moines. Combined with \$759,000 of additional net stock purchases related to collateral on new advances, this resulted in a decrease in our investment in FHLB stock from \$11.2 million at December 31, 2014 to \$4.8 million at December 31, 2015.

The Company evaluated its investment in the stock of the FHLB Des Moines for impairment. Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment and the liquidity position of the FHLB Des Moines, the Company did not consider its FHLB stock other-than-temporarily impaired.

**(6) Federal Reserve Bank Stock**

The Bank, as a member of the Federal Reserve System, is required to hold shares of capital stock of the Federal Reserve Bank of San Francisco equal to six percent of capital and surplus of the Bank. At December 31, 2015 and 2014, the Bank met such requirement. At December 31, 2015 and 2014, the Bank owned \$3.0 million and \$2.9 million of capital stock of the Federal Reserve Bank of San Francisco.

The Company evaluated its investment in the stock of the Federal Reserve Bank of San Francisco for impairment. Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment and the liquidity position of the FRB of San Francisco, the Company did not consider its FRB stock other-than-temporarily impaired.

Table of Contents**(7) Loans Receivable and Allowance for Loan Losses**

The components of loans receivable are as follows:

<b>(Dollars in thousands)</b>	<b>December 31,</b>	
	<b>2015</b>	<b>2014</b>
Real estate loans:		
First mortgages:		
One- to four-family residential	\$ 1,145,904	\$ 926,074
Multi-family residential	9,834	8,920
Construction, commercial, and other	19,288	18,415
Home equity loans and lines of credit	15,333	15,992
Total real estate loans	1,190,359	969,401
Other loans:		
Loans on deposit accounts	304	441
Consumer and other loans	4,239	4,173
Total other loans	4,543	4,614
Less:		
Net unearned fees and discounts	(4,087)	(4,112)
Allowance for loan losses	(2,166)	(1,691)
Total unearned fees, discounts and allowance for loan losses	(6,253)	(5,803)
Loans receivable, net	\$ 1,188,649	\$ 968,212

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

(Dollars in thousands)	Residential Mortgage	Construction, Commercial and Other Mortgage Loans	Home Equity Loans and Lines of Credit	Consumer and Other	Unallocated	Totals
<b>2015:</b>						
Balance, beginning of year	\$ 413	\$ 977	\$ 5	\$ 263	\$ 33	\$ 1,691
Provision (reversal of allowance) for loan losses	964	(471)	(49)	(150)	161	455
	1,377	506	(44)	113	194	2,146
Charge-offs				(53)		(53)
Recoveries	3	11	47	12		73
Net charge-offs	3	11	47	(41)		20
Balance, end of year	\$ 1,380	\$ 517	\$ 3	\$ 72	\$ 194	\$ 2,166
<b>2014:</b>						
Balance, beginning of year	\$ 376	\$ 799	\$ 10	\$ 229	\$ 72	\$ 1,486
Provision (reversal of allowance) for loan losses	146	176	1	76	(39)	360
	522	975	11	305	33	1,846
Charge-offs	(118)		(10)	(57)		(185)
Recoveries	9	2	4	15		30
Net charge-offs	(109)	2	(6)	(42)		(155)
Balance, end of year	\$ 413	\$ 977	\$ 5	\$ 263	\$ 33	\$ 1,691
<b>2013:</b>						
Balance, beginning of year	\$ 590	\$ 818	\$ 35	\$ 107	\$ 122	\$ 1,672
Provision (reversal of allowance) for loan losses	(150)	(31)	18	252	(50)	39
	440	787	53	359	72	1,711
Charge-offs	(299)		(50)	(146)		(495)
Recoveries	235	12	7	16		270
Net charge-offs	(64)	12	(43)	(130)		(225)
Balance, end of year	\$ 376	\$ 799	\$ 10	\$ 229	\$ 72	\$ 1,486

The allowance for loan loss for each segment of the loan portfolio is generally determined by calculating the historical loss of each segment for a three- to five-year look-back period and adding a qualitative adjustment for the following factors:

- changes in lending policies and procedures, including changes in underwriting standards and collections, charge-off and recovery practices;
- changes in international, national, and local economic trends;
- changes in the types of loans in the loan portfolio;
- changes in the experience and ability of personnel in the mortgage loan origination and loan servicing departments;

- changes in the number and amount of delinquent loans and classified assets;
- changes in the type and volume of loans being originated;
- changes in the value of underlying collateral for collateral dependent loans;
- changes in any concentration of credit; and
- external factors such as competition, legal and regulatory requirements on the level of estimated credit losses in the existing loan portfolio.

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In 2014, the Company extended the look-back period that is used to calculate the historical loss rates from three to five years. The look-back period was extended to five years because the longer look-back is considered to be more representative of an entire economic cycle.

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 December 31, 2015 to be at an appropriate level to provide for probable losses that can be reasonably estimated based on general and specific conditions at that date. While the Company uses the best information it has available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. To the extent actual outcomes differ from the estimates, additional provisions for credit losses may be required that would reduce future earnings. In addition, as an integral part of their examination process, the bank regulators periodically review the allowance for loan losses and may require the Company to increase the allowance based on their analysis of information available at the time of their examination.

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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	Totals
<b>December 31, 2015:</b>						
Allowance for loan losses:						
Ending allowance balance:						
Individually evaluated for impairment	\$	\$	\$	\$	\$	\$
Collectively evaluated for impairment	1,380	517	3	72	194	2,166
Total ending allowance balance	\$ 1,380	\$ 517	\$ 3	\$ 72	\$ 194	\$ 2,166
Loans:						
Ending loan balance:						
Individually evaluated for impairment	\$ 6,486	\$	\$ 124	\$ 9	\$	\$ 6,619
Collectively evaluated for impairment	1,145,259	19,175	15,216	4,546		1,184,196
Total ending loan balance	\$ 1,151,745	\$ 19,175	\$ 15,340	\$ 4,555	\$	\$ 1,190,815
<b>December 31, 2014:</b>						
Allowance for loan losses:						
Ending allowance balance:						
Individually evaluated for impairment	\$	\$	\$	\$	\$	\$
Collectively evaluated for impairment	413	977	5	263	33	1,691
Total ending allowance balance	\$ 413	\$ 977	\$ 5	\$ 263	\$ 33	\$ 1,691
Loans:						
Ending loan balance:						
Individually evaluated for impairment	\$ 6,158	\$	\$ 296	\$ 4	\$	\$ 6,458
Collectively evaluated for impairment	924,732	18,399	15,702	4,612		963,445
Total ending loan balance	\$ 930,890	\$ 18,399	\$ 15,998	\$ 4,616	\$	\$ 969,903



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

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance
<b>December 31, 2015:</b>		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 6,486	\$ 7,307
Home equity loans and lines of credit	124	163
Consumer and other	9	9
Total	\$ 6,619	\$ 7,479
<b>December 31, 2014:</b>		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 6,158	\$ 6,775
Home equity loans and lines of credit	296	324
Consumer and other	4	4
Total	\$ 6,458	\$ 7,103
<b>December 31, 2013:</b>		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 8,373	\$ 8,716
Home equity loans and lines of credit	160	165
Total	\$ 8,533	\$ 8,881

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

(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized
<b>2015:</b>		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 6,642	\$ 71
Home equity loans and lines of credit	131	
Consumer and other	9	
Total	\$ 6,782	\$ 71
<b>2014:</b>		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 6,383	\$ 118
Home equity loans and lines of credit	309	
Consumer and other	4	
Total	\$ 6,696	\$ 118
<b>2013:</b>		
With no related allowance recorded:		
One- to four-family residential mortgages	\$ 8,451	\$ 130
Home equity loans and lines of credit	160	
Total	\$ 8,611	\$ 130

There were no loans individually evaluated for impairment with a related allowance for loan loss as of December 31, 2015, 2014 or 2013. 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
December 31, 2015:										
One- to four-family residential mortgages	\$ 1,354				\$ 1,615	\$ 2,969	\$ 1,138,966	\$ 1,141,935	\$ 5,282	\$
Multi-family residential mortgages							9,810	9,810		
Construction, commercial and other mortgages							19,175	19,175		
Home equity loans and lines of credit							15,340	15,340	124	
Loans on deposit accounts							304	304		
Consumer and other	4		1		10	15	4,236	4,251	9	
<b>Total</b>	<b>\$ 1,358</b>	<b>\$</b>	<b>\$ 1</b>	<b>\$</b>	<b>\$ 1,625</b>	<b>\$ 2,984</b>	<b>\$ 1,187,831</b>	<b>\$ 1,190,815</b>	<b>\$ 5,415</b>	<b>\$</b>
December 31, 2014:										
One- to four-family residential mortgages	\$ 1,040		\$ 736		\$ 593	\$ 2,369	\$ 919,624	\$ 921,993	\$ 4,153	\$
Multi-family residential mortgages							8,897	8,897		
Construction, commercial and other mortgages							18,399	18,399		
Home equity loans and lines of credit					161	161	15,837	15,998	296	
Loans on deposit accounts							440	440		
Consumer and other	7		1		4	12	4,164	4,176	4	
<b>Total</b>	<b>\$ 1,047</b>	<b>\$</b>	<b>\$ 737</b>	<b>\$</b>	<b>\$ 758</b>	<b>\$ 2,542</b>	<b>\$ 967,361</b>	<b>\$ 969,903</b>	<b>\$ 4,453</b>	<b>\$</b>

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

The Company had 23 nonaccrual loans with a book value of \$5.4 million at December 31, 2015 and 18 nonaccrual loans with a book value of \$4.5 million as of December 31, 2014. The Company collected interest on nonaccrual loans of \$233,000, \$244,000 and \$164,000 during 2015,

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2014 and 2013, respectively, but due to regulatory requirements, the Company recorded it as a reduction of principal. The Company would have recognized additional interest income of \$312,000, \$204,000 and \$222,000 during 2015, 2014, and 2013, 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 December 31, 2015, 2014 or 2013.

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There were no loans modified in a troubled debt restructuring during the year ended December 31, 2015 or 2014. There were no new troubled debt restructurings within the past 12 months that subsequently defaulted.

The Company had 15 troubled debt restructurings totaling \$3.4 million as of December 31, 2015 that were considered to be impaired. This total included 14 one- to four-family residential mortgage loans totaling \$3.3 million and one home equity loan for \$120,000. Four of the loans, totaling \$885,000, were performing in accordance with their restructured terms and accruing interest at December 31, 2015. Nine of the loans, totaling \$2.0 million, were performing in accordance with their restructured terms but not accruing interest at December 31, 2015. One of the loans, for \$318,000, was 59 days delinquent and accruing interest at December 31, 2015. One of the loans, for \$149,000, was more than 149 days delinquent and not accruing interest as of December 31, 2015. The Company had 17 troubled debt restructurings totaling \$4.6 million as of December 31, 2014 that were considered to be impaired. This total included 16 one- to four-family residential mortgage loans totaling \$4.4 million and one home equity loan for \$135,000. Six of the loans, totaling \$2.0 million, were performing in accordance with their restructured terms and accruing interest at December 31, 2014. Nine of the loans, totaling \$2.2 million, were performing in accordance with their restructured terms but not accruing interest at December 31, 2014. Two of the loans, totaling \$343,000, are delinquent and not accruing interest as of December 31, 2014. Restructurings include deferrals of interest and/or principal payments and temporary or permanent reductions in interest rates due to the financial difficulties of the borrowers. We have no commitments to lend any additional funds to these borrowers.

The Company had no real estate owned as of December 31, 2015 or 2014. There were four one-to four-family residential mortgage loans totaling \$747,000 in the process of foreclosure as of December 31, 2015, and three one-to four-family residential mortgage loans totaling \$755,000 in the process of foreclosure as of December 31, 2014.

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

During the years ended December 31, 2015, 2014 and 2013, the Company sold \$56.2 million, \$37.5 million and \$82.2 million, respectively, of mortgage loans held for sale and recognized gains of \$503,000, \$396,000 and \$1.5 million, respectively. The Company had six loans held for sale totaling \$2.1 million and \$1.0 million at December 31, 2015 and 2014, respectively.

The Company serviced loans for others of \$51.8 million, \$60.5 million and \$68.4 million at December 31, 2015, 2014, and 2013, respectively. Of these amounts, \$2.8 million, \$3.0 million, and \$3.3 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at December 31, 2015, 2014, and 2013, respectively. The amount of contractually specified servicing fees earned was \$153,000, \$179,000 and \$213,000 for 2015, 2014, and 2013, respectively. The fees are reported in service fees on loan and deposit accounts in the consolidated statements of income.

In the normal course of business, the Company has made loans to certain directors and executive officers under terms which management believes are consistent with the Company's general lending policies. Loans to directors and executive officers amounted to \$1.4 million at December 31, 2015 and \$1.5 million at December 31, 2014.

Table of Contents**(8) Accrued Interest Receivable**

The components of accrued interest receivable are as follows:

(Dollars in thousands)	December 31,	
	2015	2014
Investment securities	\$ 1,310	\$ 1,562
Loans receivable	3,369	2,872
Interest-bearing deposits	5	2
Total	\$ 4,684	\$ 4,436

**(9) Mortgage Servicing Assets**

Mortgage servicing assets are created when the Company sells mortgage loans and retains the rights to service the loans. Mortgage servicing assets are accounted for in accordance with the Transfers and Servicing topic of the FASB ASC and are initially valued at fair value and subsequently at the lower of cost or fair value. We amortize mortgage servicing assets in proportion to and over the period of estimated net servicing income. All servicing assets are grouped into categories based on the interest rate and original term of the loan sold. Mortgage servicing assets related to loan sales are recorded as a gain on sale of loans and totaled \$6,000 and \$20,000 for the years ended December 31, 2015 and 2014, respectively.

The table below presents the changes in our mortgage servicing assets:

(Dollars in thousands)	2015		2014	
Balance at beginning of year	\$	505	\$	580
Additions		6		20
Impairments		(8)		(15)
Amortization		(77)		(80)
Balance at end of year	\$	426	\$	505

The table below presents the gross carrying values, accumulated amortization, and net carrying values of our mortgage servicing assets:

(Dollars in thousands)	December 31,	
	2015	2014
Gross carrying value	\$ 1,356	\$ 1,358
Accumulated amortization	(930)	(853)
Net carrying value	\$ 426	\$ 505



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The estimated amortization expense for our mortgage servicing assets for the next five years and all years thereafter are as follows:

<b>(Dollars in thousands)</b>		
2016	\$	70
2017		55
2018		45
2019		37
2020		31
Thereafter		188
<b>Total</b>	<b>\$</b>	<b>426</b>

The Company uses a discounted cash flow model to determine the fair value of retained mortgage servicing assets. The discounted cash flow model is also used to assess impairment of servicing assets. Impairments are recorded as adjustments to amortization expense and included in service fees on loan and deposit accounts in the statements of income. Critical assumptions used in the discounted cash flow model include mortgage prepayment speeds, discount rates, cost of servicing and ancillary income.

Prepayment speed may be affected by economic factors such as home price appreciation, market interest rates, the availability of other loan products to our borrowers and customer payment patterns. Prepayment speeds include the impact of all borrower prepayments, including full payoffs, additional principal payments and the impact of loans paid off due to foreclosure liquidations. As market interest rates decline, prepayment speeds will generally increase as customers refinance existing mortgage loans under more favorable interest rate terms and anticipated cash flows will generally decline resulting in a potential reduction, or impairment, to the fair value of the mortgage servicing assets. Alternatively, an increase in market interest rates may cause a decrease in prepayment speeds and therefore an increase in the fair value of mortgage servicing assets.

The table below presents the fair values and key assumptions used in determining the fair values of our mortgage servicing assets as of December 31, 2015 and 2014:

	<b>2015</b>		<b>2014</b>	
Fair value, beginning of year (in thousands)	\$	505	\$	617
Fair value, end of year (in thousands)		441		505