

Territorial Bancorp Inc.
Form 10-Q
November 07, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period ended September 30, 2014

or

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

For transition period from to

Commission File Number 1-34403

TERRITORIAL BANCORP INC.

(Exact Name of Registrant as Specified in Charter)

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Maryland
(State or Other Jurisdiction of Incorporation)

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

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

96813
(Zip Code)

(808) 946-1400

Registrant's telephone number, including area code

Not Applicable

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

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

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

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

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company

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

Indicate the number of shares outstanding of each of the Issuer's classes of common stock as of the latest practicable date.

9,969,600 shares of Common Stock, par value \$0.01 per share, were issued and outstanding as of October 31, 2014.

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TERRITORIAL BANCORP INC.

Form 10-Q Quarterly Report

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

| | September 30, 2014 | December 31, 2013 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 64,723 | \$ 75,365 |
| Investment securities held to maturity, at amortized cost (fair value of \$592,470 and \$598,007 at September 30, 2014 and December 31, 2013, respectively) | 589,079 | 613,436 |
| Federal Home Loan Bank stock, at cost | 11,352 | 11,689 |
| Federal Reserve Bank stock, at cost | 2,904 | |
| Loans held for sale | 2,602 | 2,210 |
| Loans receivable, net | 925,484 | 856,542 |
| Accrued interest receivable | 4,450 | 4,310 |
| Premises and equipment, net | 5,844 | 6,056 |
| Bank-owned life insurance | 41,039 | 40,243 |
| Deferred income taxes receivable | 6,468 | 5,075 |
| Prepaid expenses and other assets | 2,432 | 1,978 |
| Total assets | \$ 1,656,377 | \$ 1,616,904 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Liabilities: | | |
| Deposits | \$ 1,327,254 | \$ 1,288,709 |
| Advances from the Federal Home Loan Bank | 15,000 | 15,000 |
| Securities sold under agreements to repurchase | 72,000 | 72,000 |
| Accounts payable and accrued expenses | 21,370 | 23,933 |
| Current income taxes payable | 1,366 | 1,414 |
| Advance payments by borrowers for taxes and insurance | 2,301 | 3,708 |
| Total liabilities | 1,439,291 | 1,404,764 |
| 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 9,969,600 and 10,051,377 shares at September 30, 2014 and December 31, 2013, respectively | 100 | 101 |
| Additional paid-in capital | 75,371 | 77,340 |
| Unearned ESOP shares | (6,973) | (7,340) |
| Retained earnings | 152,295 | 145,826 |
| Accumulated other comprehensive loss | (3,707) | (3,787) |

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| | | |
|--|--------------|--------------|
| Total stockholders' equity | 217,086 | 212,140 |
| Total liabilities and stockholders' equity | \$ 1,656,377 | \$ 1,616,904 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| Interest and dividend income: | | | | |
| Investment securities | \$ 4,895 | \$ 4,775 | \$ 15,055 | \$ 13,847 |
| Loans | 10,020 | 9,267 | 29,320 | 27,696 |
| Other investments | 75 | 49 | 153 | 213 |
| Total interest and dividend income | 14,990 | 14,091 | 44,528 | 41,756 |
| Interest expense: | | | | |
| Deposits | 1,138 | 1,031 | 3,332 | 3,225 |
| Advances from the Federal Home Loan Bank | 67 | 67 | 199 | 235 |
| Securities sold under agreements to repurchase | 346 | 422 | 1,032 | 1,370 |
| Total interest expense | 1,551 | 1,520 | 4,563 | 4,830 |
| Net interest income | 13,439 | 12,571 | 39,965 | 36,926 |
| Provision for loan losses | 23 | 45 | 188 | 47 |
| Net interest income after provision for loan losses | 13,416 | 12,526 | 39,777 | 36,879 |
| Noninterest income: | | | | |
| Service fees on loan and deposit accounts | 555 | 598 | 1,578 | 1,667 |
| Income on bank-owned life insurance | 265 | 295 | 797 | 774 |
| Gain on sale of investment securities | 392 | 922 | 1,047 | 2,834 |
| Gain on sale of loans | 118 | 365 | 283 | 1,390 |
| Other | 68 | 143 | 330 | 329 |
| Total noninterest income | 1,398 | 2,323 | 4,035 | 6,994 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 5,402 | 5,318 | 16,062 | 15,682 |
| Occupancy | 1,474 | 1,387 | 4,305 | 3,971 |
| Equipment | 956 | 853 | 2,775 | 2,576 |
| Federal deposit insurance premiums | 202 | 193 | 602 | 574 |
| Other general and administrative expenses | 1,045 | 969 | 2,946 | 3,228 |
| Total noninterest expense | 9,079 | 8,720 | 26,690 | 26,031 |
| Income before income taxes | 5,735 | 6,129 | 17,122 | 17,842 |
| Income taxes | 2,273 | 2,298 | 6,479 | 6,709 |
| Net income | \$ 3,462 | \$ 3,831 | \$ 10,643 | \$ 11,133 |
| Basic earnings per share | | | | |
| Basic earnings per share | \$ 0.38 | \$ 0.40 | \$ 1.16 | \$ 1.13 |
| Diluted earnings per share | | | | |
| Diluted earnings per share | \$ 0.37 | \$ 0.39 | \$ 1.15 | \$ 1.12 |
| Cash dividends declared per common share | \$ 0.15 | \$ 0.13 | \$ 0.44 | \$ 0.38 |
| Basic weighted-average shares outstanding | 9,218,745 | 9,676,304 | 9,190,476 | 9,810,725 |
| Diluted weighted-average shares outstanding | 9,323,306 | 9,809,987 | 9,283,425 | 9,930,438 |

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See accompanying notes to consolidated financial statements.

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TERRITORIAL BANCORP INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in thousands)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 3,462 | \$ 3,831 | \$ 10,643 | \$ 11,133 |
| Change in unrealized loss on securities | 1 | 3 | 5 | 21 |
| Noncredit related gains on securities not expected to be sold | 3 | 14 | 75 | 83 |
| Other comprehensive income | 4 | 17 | 80 | 104 |
| Comprehensive income | \$ 3,466 | \$ 3,848 | \$ 10,723 | \$ 11,237 |

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands, except per share data)

| | Common Stock | Additional Paid-in Capital | Unearned ESOP Shares | Retained Earnings | Accumulated Other Comprehensive (Loss)/Income | Total Stockholders Equity |
|---|-----------------|----------------------------------|----------------------------|----------------------|--|---------------------------------|
| Balances at December 31, 2012 | \$ 108 | \$ 93,616 | \$ (7,829) | \$ 137,410 | \$ (4,333) | \$ 218,972 |
| Net income | | | | 11,133 | | 11,133 |
| Other comprehensive income | | | | | 104 | 104 |
| Cash dividends declared (\$0.38 per share) | | | | (3,896) | | (3,896) |
| Share-based compensation | 1 | 2,001 | | | | 2,002 |
| Allocation of 36,699 ESOP shares | | 478 | 367 | | | 845 |
| Repurchase of 739,197 shares of company common stock | (7) | (16,564) | | | | (16,571) |
| Balances at September 30, 2013 | \$ 102 | \$ 79,531 | \$ (7,462) | \$ 144,647 | \$ (4,229) | \$ 212,589 |
| Balances at December 31, 2013 | \$ 101 | \$ 77,340 | \$ (7,340) | \$ 145,826 | \$ (3,787) | \$ 212,140 |
| Net income | | | | 10,643 | | 10,643 |
| Other comprehensive income | | | | | 80 | 80 |
| Cash dividends declared (\$0.44 per share) | | | | (4,174) | | (4,174) |
| Share-based compensation | 1 | 2,001 | | | | 2,002 |
| Allocation of 36,699 ESOP shares | | 410 | 367 | | | 777 |
| Repurchase of 195,109 shares of company common stock | (2) | (4,380) | | | | (4,382) |
| Balances at September 30, 2014 | \$ 100 | \$ 75,371 | \$ (6,973) | \$ 152,295 | \$ (3,707) | \$ 217,086 |

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2014 | 2013 |
| Cash flows from operating activities: | | |
| Net income | \$ 10,643 | \$ 11,133 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 188 | 47 |
| Depreciation and amortization | 1,032 | 837 |
| Deferred income tax benefit | (1,445) | (1,108) |
| Amortization of fees, discounts, and premiums | (310) | 395 |
| Origination of loans held for sale | (27,195) | (67,252) |
| Proceeds from sales of loans held for sale | 27,086 | 70,181 |
| Gain on sale of loans, net | (283) | (1,390) |
| 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 | (1,017) | (2,834) |
| ESOP expense | 777 | 845 |
| Share-based compensation expense | 2,002 | 2,002 |
| Increase in accrued interest receivable | (140) | (15) |
| Net increase in bank-owned life insurance | (796) | (774) |
| Net (increase) decrease in prepaid expenses and other assets | (454) | 1,379 |
| Net increase (decrease) in accounts payable and accrued expenses | (2,038) | 2,255 |
| Net decrease in advance payments by borrowers for taxes and insurance | (1,407) | (1,256) |
| Net decrease in income taxes payable | (48) | (244) |
| Net cash provided by operating activities | 6,595 | 14,201 |
| Cash flows from investing activities: | | |
| Purchases of investment securities held to maturity | (34,831) | (240,496) |
| Principal repayments on investment securities held to maturity | 48,705 | 146,301 |
| Proceeds from sale of investment securities held to maturity | 11,506 | 42,034 |
| Loan originations, net of principal repayments on loans receivable | (68,694) | (52,345) |
| Proceeds from redemption of Federal Home Loan Bank stock | 337 | 330 |
| Purchases of Federal Reserve Bank stock | (2,904) | |
| Purchases of bank-owned life insurance | | (8,000) |
| Purchases of premises and equipment | (820) | (922) |
| Net cash used in investing activities | (46,701) | (113,098) |

(Continued)

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

| | Nine Months Ended September 30, | |
|---|--|-------------|
| | 2014 | 2013 |
| Cash flows from financing activities: | | |
| Net increase in deposits | \$ 38,545 | \$ 20,511 |
| Proceeds from advances from the Federal Home Loan Bank | | 5,000 |
| Repayments of advances from the Federal Home Loan Bank | | (10,000) |
| Repayments of securities sold under agreements to repurchase | | (23,000) |
| Purchases of Fed Funds | 10 | |
| Sales of Fed Funds | (10) | |
| Repurchases of company stock | (4,907) | (16,571) |
| Cash dividends paid | (4,174) | (3,896) |
| Net cash provided by (used in) financing activities | 29,464 | (27,956) |
| Net decrease in cash and cash equivalents | (10,642) | (126,853) |
| Cash and cash equivalents at beginning of the period | 75,365 | 182,818 |
| Cash and cash equivalents at end of the period | \$ 64,723 | \$ 55,965 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for: | | |
| Interest on deposits and borrowings | \$ 4,502 | \$ 4,861 |
| Income taxes | 7,972 | 8,061 |
| Supplemental disclosure of noncash investing activities: | | |
| Loans transferred to real estate owned | \$ | \$ 143 |
| Investments purchased, not settled | | 1,096 |

See accompanying notes to consolidated financial statements.

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TERRITORIAL BANCORP INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

(1) Basis of Presentation

The accompanying unaudited consolidated financial statements of Territorial Bancorp Inc. (the Company) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. These interim condensed consolidated financial statements and notes should be read in conjunction with Territorial Bancorp Inc.'s consolidated financial statements and notes thereto filed as part of the Annual Report on Form 10-K for the year ended December 31, 2013. In the opinion of management, all adjustments necessary for a fair presentation have been made and include all normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year.

(2) Organization

On November 4, 2008, the Board of Directors of Territorial Mutual Holding Company (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.

Upon completion of the conversion and reorganization, a special liquidation account was established in an amount equal to the total equity of Territorial Mutual Holding Company as of December 31, 2008. The liquidation account is to provide eligible account holders and supplemental eligible account holders who maintain their deposit accounts with Territorial Savings Bank after the conversion with a liquidation interest in the unlikely event of the complete liquidation of Territorial Savings Bank after the conversion. The balance of the liquidation account at December 31, 2013 was \$17.6 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.

Table of Contents**(3) Recently Adopted 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 is effective for interim and annual periods beginning after December 15, 2014, with early adoption allowed. The Company does not expect the adoption of this amendment to 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. 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 is effective for interim and annual periods beginning after December 15, 2014, with early adoption prohibited. The Company does not expect the adoption of this amendment to 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 is effective for interim and annual periods beginning after December 15, 2014. The Company does not expect the adoption of this amendment to have any effect on its consolidated financial statements.

(4) Cash and Cash Equivalents

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

| (Dollars in thousands) | September 30, 2014 | December 31, 2013 |
|--|-----------------------|----------------------|
| Cash and due from banks | \$ 8,036 | \$ 9,962 |
| Interest-earning deposits in other banks | 56,687 | 65,403 |
| Cash and cash equivalents | \$ 64,723 | \$ 75,365 |

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

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(5) **Investment Securities**

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

| (Dollars in thousands) | Carrying Value | | Gains | | Gross Unrealized Losses | | Estimated Fair Value |
|--|-------------------|-----------|---------------|-----------|----------------------------|-----------|-------------------------|
| September 30, 2014: | | | | | | | |
| Held to maturity: | | | | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 588,418 | \$ | 13,269 | \$ | (9,878) | \$ | 591,809 |
| Trust preferred securities | 661 | | | | | | 661 |
| Total | \$ 589,079 | \$ | 13,269 | \$ | (9,878) | \$ | 592,470 |
| December 31, 2013: | | | | | | | |
| Held to maturity: | | | | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 612,899 | \$ | 7,979 | \$ | (23,408) | \$ | 597,470 |
| Trust preferred securities | 537 | | | | | | 537 |
| Total | \$ 613,436 | \$ | 7,979 | \$ | (23,408) | \$ | 598,007 |

The carrying and estimated fair value of investment securities at September 30, 2014 are shown below. Incorporated in the maturity schedule are mortgage-backed and trust preferred securities, which are allocated using the contractual maturity as a basis. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands) | Carrying Value | | Estimated Fair Value |
|------------------------------------|-------------------|-----------|-------------------------|
| Held to maturity: | | | |
| Due within 5 years | \$ 7 | \$ | 7 |
| Due after 5 years through 10 years | 61 | | 65 |
| Due after 10 years | 589,011 | | 592,398 |
| Total | \$ 589,079 | \$ | 592,470 |

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

| (Dollars in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Proceeds from sales | \$ 4,307 | \$ 13,943 | \$ 16,577 | \$ 43,131 |
| Gross gains | 392 | 922 | 1,047 | 2,834 |
| Gross losses | | | | |

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During the three months ended September 30, 2014 and 2013, the Company recorded proceeds of \$4.3 million and \$13.9 million, respectively, from the sale of \$3.9 million and \$13.0 million, respectively, of held-to-maturity debt securities, resulting in gross realized gains of \$392,000 and \$922,000, respectively. During the nine months ended September 30, 2014 and 2013, the Company recorded proceeds of \$11.5 million and \$43.1 million, respectively, from the sale of \$10.5 million and \$40.3 million, respectively, of held-to-maturity debt securities, resulting in gross realized gains of \$1.0 million and \$2.8 million, respectively. The sale of these securities, for which the Company had already collected a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio.

Investment securities with carrying values of \$273.9 million and \$273.2 million at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase and transaction clearing accounts.

Provided below is a summary of investment securities which were in an unrealized loss position at September 30, 2014 and December 31, 2013. The Company does not intend to sell these securities until such time as the value recovers or the securities mature and it is not more likely than not that the Company will be required to sell the securities prior to recovery of value or the securities mature.

| Description of Securities (Dollars in thousands) | Less Than 12 Months | | 12 Months or Longer | | Number of Securities | Total | | |
|---|---------------------|----------------------|---------------------|----------------------|-------------------------|------------|----------------------|--|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | Fair Value | Unrealized Losses | |
| September 30, 2014: | | | | | | | | |
| Mortgage-backed securities | \$ 26,763 | \$ 142 | \$ 215,945 | \$ 9,736 | 45 | \$ 242,708 | \$ 9,878 | |
| December 31, 2013: | | | | | | | | |
| Mortgage-backed securities | \$ 361,445 | \$ 21,678 | \$ 22,010 | \$ 1,730 | 69 | \$ 383,455 | \$ 23,408 | |

Mortgage-Backed Securities. The unrealized losses on the Company's investment in mortgage-backed securities were caused by increases in market interest rates. All of the mortgage-backed securities are guaranteed by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. Since the decline in market value is attributable to changes in interest rates and not credit quality, and the Company does not intend to sell these investments until maturity and it is not more likely than not that the Company will be required to sell such investments prior to recovery of its amortized cost basis, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2014 and December 31, 2013.

Trust Preferred Securities. At September 30, 2014, the Company owns two trust preferred securities, PreTSL XXIII and XXIV. The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. Both of these securities are classified in the Company's held-to-maturity investment portfolio.

The trust preferred securities market is considered to be inactive as only five transactions have occurred over the past 33 months in the same tranche of securities owned by the Company. The Company used a discounted cash flow model to determine whether these securities are other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows.

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Based on the Company's review, the Company's investment in trust preferred securities did not incur additional impairment during the quarter ending September 30, 2014.

PreTSL XXIV has a book value of \$0 at September 30, 2014. PreTSL XXIII has a book value of \$661,000 at September 30, 2014. The difference between the book value of \$661,000 and the remaining amortized cost basis of \$1.1 million is reported as other comprehensive loss and is related to noncredit factors such as the trust preferred securities market being inactive.

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

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

| (Dollars in thousands) | 2014 | | 2013 | |
|--|------|-------|------|-------|
| Balance at January 1, | \$ | 5,885 | \$ | 5,885 |
| Credit losses on debt securities for which other-than-temporary impairment was not previously recognized | | | | |
| Balance at September 30, | \$ | 5,885 | \$ | 5,885 |

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

| (Dollars in thousands) | September 30, | | 2013 | |
|--|---------------|-----|------|-----|
| | 2014 | | | |
| Noncredit losses on other-than-temporarily impaired securities, net of taxes | \$ | 301 | \$ | 362 |

(6) Loans Receivable and Allowance for Loan Losses

The components of loans receivable are as follows:

| (Dollars in thousands) | September 30, | | December 31, | |
|---------------------------------|---------------|---------|--------------|---------|
| | 2014 | | 2013 | |
| Real estate loans: | | | | |
| First mortgages: | | | | |
| One- to four-family residential | \$ | 885,540 | \$ | 823,273 |
| Multi-family residential | | 5,151 | | 4,877 |

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| | | |
|--|------------|------------|
| Construction, commercial, and other | 20,359 | 13,554 |
| Home equity loans and lines of credit | 15,787 | 16,524 |
| Total real estate loans | 926,837 | 858,228 |
| Other loans: | | |
| Loans on deposit accounts | 462 | 342 |
| Consumer and other loans | 4,097 | 4,307 |
| Total other loans | 4,559 | 4,649 |
| Less: | | |
| Net unearned fees and discounts | (4,384) | (4,849) |
| Allowance for loan losses | (1,528) | (1,486) |
| Total unearned fees, discounts and allowance for loan losses | (5,912) | (6,335) |
| Loans receivable, net | \$ 925,484 | \$ 856,542 |

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

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|------------------------------|-------------------------------------|----------|----------|------------------------------------|------|------|
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Balance, beginning of period | \$ 1,510 | \$ 1,622 | \$ 1,486 | \$ 1,672 | | |
| Provision for loan losses | 23 | 45 | 188 | 47 | | |
| | 1,533 | 1,667 | 1,674 | 1,719 | | |
| Charge-offs | (10) | (68) | (163) | (205) | | |
| Recoveries | 5 | 68 | 17 | 153 | | |
| Net charge-offs | (5) | | (146) | (52) | | |
| Balance, end of period | \$ 1,528 | \$ 1,667 | \$ 1,528 | \$ 1,667 | | |

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

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

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

Management considers the allowance for loan losses at September 30, 2014 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 regulatory agencies 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 |
|---------------------------------------|-------------------------|---|---|-----------------------|-------------|------------|
| September 30, 2014: | | | | | | |
| Allowance for loan losses: | | | | | | |
| Ending allowance balance: | | | | | | |
| Individually evaluated for impairment | \$ | \$ | \$ | \$ | \$ | \$ |
| Collectively evaluated for impairment | 353 | 1,011 | 7 | 147 | 10 | 1,528 |
| Total ending allowance balance | \$ 353 | \$ 1,011 | \$ 7 | \$ 147 | \$ 10 | \$ 1,528 |
| Loans: | | | | | | |
| Ending loan balance: | | | | | | |
| Individually evaluated for impairment | \$ 6,739 | \$ | \$ 301 | \$ 1 | \$ | \$ 7,041 |
| Collectively evaluated for impairment | 879,573 | 20,344 | 15,492 | 4,562 | | 919,971 |
| Total ending loan balance | \$ 886,312 | \$ 20,344 | \$ 15,793 | \$ 4,563 | \$ | \$ 927,012 |
| December 31, 2013: | | | | | | |
| Allowance for loan losses: | | | | | | |
| Ending allowance balance: | | | | | | |
| Individually evaluated for impairment | \$ | \$ | \$ | \$ | \$ | \$ |
| Collectively evaluated for impairment | 376 | 799 | 10 | 229 | 72 | 1,486 |
| Total ending allowance balance | \$ 376 | \$ 799 | \$ 10 | \$ 229 | \$ 72 | \$ 1,486 |
| Loans: | | | | | | |
| Ending loan balance: | | | | | | |
| Individually evaluated for impairment | \$ 8,373 | \$ | \$ 160 | \$ | \$ | \$ 8,533 |
| Collectively evaluated for impairment | 814,960 | 13,514 | 16,372 | 4,649 | | 849,495 |
| Total ending loan balance | \$ 823,333 | \$ 13,514 | \$ 16,532 | \$ 4,649 | \$ | \$ 858,028 |

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

| (Dollars in thousands) | September 30, 2014 | December 31, 2013 |
|---|-----------------------|----------------------|
| Loans with no allocated allowance for loan losses | \$ 7,041 | \$ 8,533 |
| Loans with allocated allowance for loan losses | | |
| Total impaired loans | \$ 7,041 | \$ 8,533 |
| Amount of allocated loan loss allowance | \$ | \$ |

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

| (Dollars in thousands) | Recorded Investment | Unpaid Principal Balance |
|---|------------------------|--------------------------------|
| September 30, 2014: | | |
| With no related allowance recorded: | | |
| One- to four-family residential mortgages | \$ 6,739 | \$ 7,327 |
| Home equity loans and lines of credit | 301 | 324 |
| Consumer and other | 1 | 1 |
| Total | \$ 7,041 | \$ 7,652 |
| December 31, 2013: | | |
| 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 |

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

| (Dollars in thousands) | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|----------------------------------|--|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| 2014: | | | | |
| With no related allowance recorded: | | | | |
| One- to four-family residential mortgages | \$ 6,785 | \$ 28 | \$ 6,931 | \$ 88 |
| Home equity loans and lines of credit | 302 | | 311 | |
| Consumer and other | 1 | | 1 | |
| Total | \$ 7,088 | \$ 28 | \$ 7,243 | \$ 88 |
| 2013: | | | | |
| With no related allowance recorded: | | | | |
| One- to four-family residential mortgages | \$ 7,440 | \$ 33 | \$ 7,477 | \$ 98 |
| Home equity loans and lines of credit | 162 | | 161 | |
| Total | \$ 7,602 | \$ 33 | \$ 7,638 | \$ 98 |

There were no loans individually evaluated for impairment with a related allowance for loan loss as of September 30, 2014 or December 31, 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 |
|--|------------------|------------------|------------------|------------------|-----------------------------|-----------------|--------------------|-------------------|------------------|---|
| September 30, 2014: | | | | | | | | | | |
| One- to four-family residential mortgages | \$ 402 | | \$ 840 | | \$ 722 | \$ 1,964 | \$ 879,217 | \$ 881,181 | \$ 4,726 | \$ |
| Multi-family residential mortgages | | | | | | | 5,131 | 5,131 | | |
| Construction, commercial and other mortgages | | | | | | | 20,344 | 20,344 | | |
| Home equity loans and lines of credit | | | | | 161 | 161 | 15,632 | 15,793 | 301 | |
| Loans on deposit accounts | | | | | | | 462 | 462 | | |
| Consumer and other | 11 | | 2 | | 1 | 14 | 4,087 | 4,101 | 1 | |
| Total | \$ 413 | | \$ 842 | | \$ 884 | \$ 2,139 | \$ 924,873 | \$ 927,012 | \$ 5,028 | \$ |
| December 31, 2013: | | | | | | | | | | |
| One- to four-family residential mortgages | \$ 376 | | \$ 612 | | \$ 1,577 | \$ 2,565 | \$ 815,917 | \$ 818,482 | \$ 5,840 | \$ |
| Multi-family residential mortgages | | | | | | | 4,851 | 4,851 | | |
| Construction, commercial and other mortgages | | | | | | | 13,514 | 13,514 | | |
| Home equity loans and lines of credit | | | | | | | 16,532 | 16,532 | 160 | |
| Loans on deposit accounts | | | | | | | 342 | 342 | | |
| Consumer and other | 11 | | 4 | | | 15 | 4,292 | 4,307 | | |
| Total | \$ 387 | | \$ 616 | | \$ 1,577 | \$ 2,580 | \$ 855,448 | \$ 858,028 | \$ 6,000 | \$ |

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

The Company had 20 nonaccrual loans with a book value of \$5.0 million at September 30, 2014 and 19 nonaccrual loans with a book value of \$6.0 million as of December 31, 2013. The Company collected interest on nonaccrual loans of \$197,000 and \$137,000 during the nine months ended September 30, 2014 and 2013, respectively, but due to regulatory requirements, we recorded it as a reduction of principal. The Company would have recognized additional interest income of \$164,000 and \$200,000 during the nine months ended September 30, 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 September 30, 2014 and December 31, 2013.

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The table below presents information related to loans modified in a troubled debt restructuring during the three and nine months ended September 30, 2014 and 2013:

| (Dollars in thousands) | Number of Loans | 2014 Pre- Modification Recorded Investment | Post- Modification Recorded Investment | Number of Loans | 2013 Pre- Modification Recorded Investment | Post- Modification Recorded Investment |
|---|--------------------|--|---|--------------------|--|---|
| Three months ended September 30: | | | | | | |
| One- to four-family residential | | \$ | \$ | | \$ | \$ |
| Total | | \$ | \$ | | \$ | \$ |
| Nine months ended September 30: | | | | | | |
| One- to four-family residential | | \$ | \$ | 1 | \$ 700 | \$ 700 |
| Total | | \$ | \$ | 1 | \$ 700 | \$ 700 |

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

The Company had 18 troubled debt restructurings totaling \$4.9 million as of September 30, 2014 that were considered to be impaired. This total included 17 one- to four-family residential mortgage loans totaling \$4.8 million and one home equity loan for \$139,000. Six of the loans, totaling \$2.0 million, are performing in accordance with their restructured terms and accruing interest at September 30, 2014. Eleven of the loans, totaling \$2.7 million, are performing in accordance with their restructured terms but not accruing interest at September 30, 2014. One of the loans, for \$191,000, is more than 149 days delinquent and not accruing interest as of September 30, 2014. The Company had 20 troubled debt restructurings totaling \$5.8 million as of December 31, 2013 that were considered to be impaired. This total included 19 one- to four-family residential mortgage loans totaling \$5.6 million and one home equity loan for \$160,000. Eight of the loans, totaling \$2.5 million, were performing in accordance with their restructured terms and accruing interest at December 31, 2013. Twelve of the loans, totaling \$3.3 million, were performing in accordance with their restructured terms but not accruing interest at December 31, 2013. Restructurings include deferrals of interest and/or principal payments and temporary or permanent reductions in interest rates due to the financial difficulties of the borrowers. We have no commitments to lend any additional funds to these borrowers.

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

During the nine months ended September 30, 2014 and 2013, the Company sold \$26.9 million and \$69.2 million, respectively, of mortgage loans held for sale and recognized gains of \$283,000 and \$1.4 million, respectively. During the three months ended September 30, 2014 and 2013, the Company sold \$10.0 million and \$22.1 million, respectively, of mortgage loans held for sale and recognized gains of \$118,000 and \$365,000, respectively. The Company had eight loans held for sale totaling \$2.6 million at September 30, 2014 and six loans held for sale totaling \$2.2 million at December 31, 2013.

The Company serviced loans for others of \$62.8 million at September 30, 2014 and \$68.4 million at December 31, 2013. Of these amounts, \$2.5 million and \$3.1 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at September 30, 2014 and December 31, 2013, respectively. The amount of contractually specified servicing fees earned for the nine-month periods ended September 30, 2014 and 2013 was \$137,000 and \$164,000, respectively. The amount of contractually specified servicing fees earned for the three-month periods ended September 30, 2014 and 2013 was \$44,000 and \$51,000, respectively. The fees are reported in service

fees on loan and deposit accounts in the consolidated statements of income.

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

Securities sold under agreements to repurchase are treated as financings and the obligations to repurchase the identical securities sold are reflected as a liability with the dollar amount of securities underlying the agreements remaining in the asset accounts. Securities sold under agreements to repurchase are summarized as follows:

| (Dollars in thousands) | September 30, 2014 | | December 31, 2013 | |
|-------------------------|----------------------|-----------------------|----------------------|-----------------------|
| | Repurchase Liability | Weighted Average Rate | Repurchase Liability | Weighted Average Rate |
| Maturing: | | | | |
| 1 year or less | \$ 47,000 | 2.11% | \$ | % |
| Over 1 year to 2 years | | | 47,000 | 2.11 |
| Over 3 years to 4 years | 25,000 | 1.46 | 25,000 | 1.46 |
| Total | \$ 72,000 | 1.88% | \$ 72,000 | 1.88% |

Below is a summary comparing the carrying value and fair value of securities pledged to secure repurchase agreements, the repurchase liability, and the amount at risk at September 30, 2014. The amount at risk is the greater of the carrying value or fair value over the repurchase liability. All the agreements to repurchase are with JP Morgan Securities and the securities pledged are issued and guaranteed by U.S. government-sponsored enterprises.

| (Dollars in thousands) | Carrying Value of Securities | Fair Value of Securities | Repurchase Liability | Amount at Risk | Weighted Average Months to Maturity |
|------------------------|------------------------------|--------------------------|----------------------|----------------|-------------------------------------|
| Maturing: | | | | | |
| Over 90 days | \$ 77,416 | \$ 77,232 | \$ 72,000 | \$ 5,416 | 16 |

(8) **Offsetting of Financial Liabilities**

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

| (Dollars in thousands) | Gross Amount of Recognized Liabilities | Gross Amount Offset in the Balance Sheet | Net Amount of Liabilities Presented in the Balance Sheet | Gross Amount Not Offset in the Balance Sheet Financial Instruments | Cash Collateral Pledged | Net Amount |
|--|--|--|--|---|-------------------------|------------|
| September 30, 2014: | | | | | | |
| Securities sold under agreements to repurchase | \$ 72,000 | \$ | \$ 72,000 | \$ 72,000 | \$ | \$ |
| December 31, 2013: | | | | | | |

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| | | | | | | | | | | | |
|--|----|--------|----|--|----|--------|----|--------|----|--|----|
| Securities sold under agreements to repurchase | \$ | 72,000 | \$ | | \$ | 72,000 | \$ | 72,000 | \$ | | \$ |
|--|----|--------|----|--|----|--------|----|--------|----|--|----|

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(9) Employee Benefit Plans

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

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

The components of net periodic benefit cost were as follows:

| (Dollars in thousands) | SERP Three Months Ended September 30, | | SERP Nine Months Ended September 30, | |
|--|---|-------|--|--------|
| | 2014 | 2013 | 2014 | 2013 |
| Net periodic benefit cost for the period | | | | |
| Service cost | \$ 25 | \$ 41 | \$ 75 | \$ 124 |
| Interest cost | 30 | 28 | 89 | 83 |
| Expected return on plan assets | | | | |
| Amortization of prior service cost | | | | |
| Recognized actuarial loss | | | | |
| Recognized curtailment loss | | | | |
| Net periodic benefit cost | \$ 55 | \$ 69 | \$ 164 | \$ 207 |

(10) Employee Stock Ownership Plan

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

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

Shares purchased by the ESOP are held by a trustee in an unallocated suspense account, and shares are released annually from the suspense account on a pro-rata basis as principal and interest payments are made by the ESOP to the Company. The trustee allocates the shares released

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among participants on the basis of each participant's proportional share of compensation relative to all participants. As shares are committed to be released from the suspense account, Territorial Savings Bank reports compensation expense based on the average fair value of shares released with a corresponding credit to stockholders

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equity. The shares committed to be released are considered outstanding for earnings per share computations. Compensation expense recognized for the three months ended September 30, 2014 and 2013 amounted to \$216,000 and \$249,000, respectively. Compensation expense recognized for the nine months ended September 30, 2014 and 2013 amounted to \$673,000 and \$772,000, respectively.

Shares held by the ESOP trust were as follows:

| | September 30, 2014 | December 31, 2013 |
|---|-----------------------|----------------------|
| Allocated shares | 271,198 | 239,241 |
| Unearned shares | 697,290 | 733,989 |
| Total ESOP shares | 968,488 | 973,230 |
| Fair value of unearned shares, in thousands | \$ 14,148 | \$ 17,029 |

The ESOP restoration plan is a nonqualified plan that provides supplemental benefits to certain executives who are prevented from receiving the full benefits contemplated by the employee stock ownership plan's benefit formula. The supplemental cash payments consist of payments representing shares that cannot be allocated to the participants under the ESOP due to IRS limitations imposed on tax-qualified plans. We accrue for these benefits over the period during which employees provide services to earn these benefits. For the three months ended September 30, 2014 and 2013, we accrued \$63,000 and \$63,000, respectively, for the ESOP restoration plan. For the nine months ended September 30, 2014 and 2013, we accrued \$156,000 and \$183,000, respectively, for the ESOP restoration plan.

(11) Share-Based Compensation

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

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

| (In thousands) | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|----------------------|---|--------|--------|--|----------|----------|
| | 2014 | 2013 | 2013 | 2014 | 2013 | 2013 |
| Compensation expense | \$ 675 | \$ 675 | \$ 675 | \$ 2,002 | \$ 2,002 | \$ 2,002 |
| Income tax benefit | 302 | 314 | 314 | 911 | 966 | 966 |

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

Stock Options

The table below presents the stock option activity for the nine months ended September 30, 2014 and 2013:

| | Options | Weighted Average Exercise Price | Remaining Contractual Life (Years) | Aggregate Intrinsic Value (in Thousands) |
|--|---------|--|--|--|
| Options outstanding at December 31, 2013 | 832,954 | \$ 17.38 | 6.68 | \$ 4,845 |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | | | | |
| Expired | | | | |
| Options outstanding at September 30, 2014 | 832,954 | \$ 17.38 | 5.93 | \$ 2,421 |
| Options outstanding at December 31, 2012 | 832,954 | \$ 17.38 | 7.67 | \$ 4,554 |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | | | | |
| Expired | | | | |
| Options outstanding at September 30, 2013 | 832,954 | \$ 17.38 | 6.92 | \$ 3,821 |
| Options vested and exercisable at September 30, 2014 | 555,097 | \$ 17.38 | 5.93 | \$ 1,615 |

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There were no stock options exercised during the three and nine months ended September 30, 2014 and 2013.

As of September 30, 2014, the Company had \$1.4 million of unrecognized compensation costs related to the stock option plan. The cost of the stock option plan is being amortized over the five- to six-year vesting period.

There were no options granted in the three or nine months ended September 30, 2014 and 2013.

Restricted Stock Awards

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

The table below presents the restricted stock award activity:

| | Restricted Stock Awards | | Weighted Average Grant Date Fair Value |
|---------------------------------|-------------------------------|----|--|
| Nonvested at December 31, 2013 | 340,065 | \$ | 17.39 |
| Granted | | | |
| Vested | 113,332 | | 17.39 |
| Forfeited | | | |
| Nonvested at September 30, 2014 | 266,733 | \$ | 17.39 |
| Nonvested at December 31, 2012 | 453,397 | \$ | 17.39 |
| Granted | | | |
| Vested | 113,332 | | 17.39 |
| Forfeited | | | |
| Nonvested at September 30, 2013 | 340,065 | \$ | 17.39 |

As of September 30, 2014, the Company had \$3.8 million of unrecognized compensation costs related to restricted stock awards. The cost of the restricted stock awards is being amortized over the five- or six-year vesting period.

(12) **Earnings Per Share**

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

| (Dollars in thousands, except share data) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 3,462 | \$ 3,831 | \$ 10,643 | \$ 11,133 |
| Weighted-average number of shares used in: | | | | |
| Basic earnings per share | 9,218,745 | 9,676,304 | 9,190,476 | 9,810,725 |
| Dilutive common stock equivalents: | | | | |
| Stock options and restricted stock units | 104,561 | 133,683 | 92,949 | 119,713 |
| Diluted earnings per share | 9,323,306 | 9,809,987 | 9,283,425 | 9,930,438 |
| Net income per common share, basic | \$ 0.38 | \$ 0.40 | \$ 1.16 | \$ 1.13 |
| Net income per common share, diluted | \$ 0.37 | \$ 0.39 | \$ 1.15 | \$ 1.12 |

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(13) Other Comprehensive Loss

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

| (Dollars in thousands) | Unfunded Pension Liability | Noncredit Related Losses on Securities Not Expected to Be Sold | Unrealized Loss on Securities | Total |
|--|----------------------------------|--|-------------------------------------|----------|
| Three months ended September 30, 2014 | | | | |
| Balances at beginning of period | \$ 3,338 | \$ 304 | \$ 69 | \$ 3,711 |
| Other comprehensive income before reclassifications | | (3) | (1) | (4) |
| Amounts reclassified from accumulated other comprehensive loss | | | | |
| Net current period other comprehensive income | | (3) | (1) | (4) |
| Balances at end of period | \$ 3,338 | \$ 301 | \$ 68 | \$ 3,707 |
| Three months ended September 30, 2013: | | | | |
| Balances at beginning of period | \$ 3,792 | \$ 376 | \$ 78 | \$ 4,246 |
| Other comprehensive income before reclassifications | | (14) | (3) | (17) |
| Amounts reclassified from accumulated other comprehensive loss | | | | |
| Net current period other comprehensive income | | (14) | (3) | (17) |
| Balances at end of period | \$ 3,792 | \$ 362 | \$ 75 | \$ 4,229 |
| Nine months ended September 30, 2014 | | | | |
| Balances at beginning of period | \$ 3,338 | \$ 376 | \$ 73 | \$ 3,787 |
| Other comprehensive income before reclassifications | | (75) | (5) | (80) |
| Amounts reclassified from accumulated other comprehensive loss | | | | |
| Net current period other comprehensive income | | (75) | (5) | (80) |
| Balances at end of period | \$ 3,338 | \$ 301 | \$ 68 | \$ 3,707 |
| Nine months ended September 30, 2013: | | | | |
| Balances at beginning of period | \$ 3,792 | \$ 445 | \$ 96 | \$ 4,333 |
| Other comprehensive income before reclassifications | | (83) | (21) | (104) |
| Amounts reclassified from accumulated other comprehensive loss | | | | |
| Net current period other comprehensive income | | (83) | (21) | (104) |
| Balances at end of period | \$ 3,792 | \$ 362 | \$ 75 | \$ 4,229 |

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

| (Dollars in thousands) | Pretax Amount | Three Months Ended September 30, | | | | After Tax Amount |
|--|---------------|----------------------------------|------------------|----------------|--------------|------------------|
| | | 2014 Tax | After Tax Amount | Pretax Amount | 2013 Tax | |
| Unfunded pension liability | \$ | \$ | \$ | \$ | \$ | \$ |
| Noncredit related losses on securities not expected to be sold | (4) | 1 | (3) | (23) | 9 | (14) |
| Unrealized loss on securities | (2) | 1 | (1) | (5) | 2 | (3) |
| Total | \$ (6) | \$ 2 | \$ (4) | \$ (28) | \$ 11 | \$ (17) |

| (Dollars in thousands) | Pretax Amount | Nine Months Ended September 30, | | | | After Tax Amount |
|--|-----------------|---------------------------------|------------------|-----------------|--------------|------------------|
| | | 2014 Tax | After Tax Amount | Pretax Amount | 2013 Tax | |
| Unfunded pension liability | \$ | \$ | \$ | \$ | \$ | \$ |
| Noncredit related losses on securities not expected to be sold | (124) | 49 | (75) | (138) | 55 | (83) |
| Unrealized loss on securities | (8) | 3 | (5) | (35) | 14 | (21) |
| Total | \$ (132) | \$ 52 | \$ (80) | \$ (173) | \$ 69 | \$ (104) |

(14) Fair Value of Financial Instruments

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

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

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

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

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

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

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

The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. The trust preferred securities market is considered to be inactive as only five transactions have occurred over the past 33 months in the same tranche of securities owned by the Company. The fair value of our trust preferred securities was determined using a discounted cash flow model. Our model used a discount rate equal to three-month LIBOR plus 20.00% and provided a fair value estimate of \$18.65 per \$100 of par value for PreTSL XXIII.

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

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

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

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

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

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

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

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

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

| (Dollars in thousands) | Carrying Amount | Fair Value | Fair Value Measurements Using | | |
|---|-----------------|------------|-------------------------------|---------|---------|
| | | | Level 1 | Level 2 | Level 3 |
| September 30, 2014 | | | | | |
| Assets | | | | | |
| Cash and cash equivalents | \$ 64,723 | \$ 64,723 | \$ 64,723 | \$ | \$ |
| Investment securities held to maturity | 589,079 | 592,470 | | 591,809 | 661 |
| FHLB stock | 11,352 | 11,352 | | 11,352 | |
| FRB stock | 2,904 | 2,904 | | 2,904 | |
| Loans held for sale | 2,602 | 2,644 | | 2,644 | |
| Loans receivable, net | 925,484 | 954,573 | | | 954,573 |
| Accrued interest receivable | 4,450 | 4,450 | 4,450 | | |
| Interest rate contracts | 14 | 14 | | 14 | |
| Liabilities | | | | | |
| Deposits | 1,327,254 | 1,327,481 | 1,114,881 | | 212,600 |
| Advances from the Federal Home Loan Bank | 15,000 | 14,998 | | | 14,998 |
| Securities sold under agreements to repurchase | 72,000 | 72,478 | | | 72,478 |
| Accounts payable and accrued expenses (excluding interest rate contracts) | 21,357 | 21,357 | 21,357 | | |
| Interest rate contracts | 13 | 13 | | 13 | |
| Current income taxes payable | 1,366 | 1,366 | 1,366 | | |
| Advance payments by borrowers for taxes and insurance | 2,301 | 2,301 | 2,301 | | |
| December 31, 2013 | | | | | |
| Assets | | | | | |
| Cash and cash equivalents | \$ 75,365 | \$ 75,365 | \$ 75,365 | \$ | \$ |
| Investment securities held to maturity | 613,436 | 598,007 | | 597,470 | 537 |
| FHLB stock | 11,689 | 11,689 | | 11,689 | |
| Loans held for sale | 2,210 | 2,252 | | 2,252 | |
| Loans receivable, net | 856,542 | 880,852 | | | 880,852 |
| Accrued interest receivable | 4,310 | 4,310 | 4,310 | | |
| Interest rate contracts | 25 | 25 | | 25 | |
| Liabilities | | | | | |
| Deposits | 1,288,709 | 1,289,348 | 1,078,712 | | 210,636 |
| Advances from the Federal Home Loan Bank | 15,000 | 15,110 | | | 15,110 |
| Securities sold under agreements to repurchase | 72,000 | 73,151 | | | 73,151 |
| Accounts payable and accrued expenses (excluding interest rate contracts) | 23,905 | 23,905 | 23,905 | | |
| Interest rate contracts | 28 | 28 | | 28 | |
| Current income taxes payable | 1,414 | 1,414 | 1,414 | | |
| Advance payments by borrowers for taxes and insurance | 3,708 | 3,708 | 3,708 | | |

At September 30, 2014 and December 31, 2013, neither the commitment fees received on commitments to extend credit nor the fair value thereof was material to the consolidated financial statements of the Company.

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

| (Dollars in thousands) | | Level 1 | Level 2 | Level 3 | Total |
|-------------------------|-------------|---------|---------|---------|-------|
| September 30, 2014: | | | | | |
| Interest rate contracts | assets | \$ | \$ | 14 | \$ 14 |
| Interest rate contracts | liabilities | | (13) | | (13) |
| December 31, 2013: | | | | | |
| Interest rate contracts | assets | \$ | \$ | 25 | \$ 25 |
| Interest rate contracts | liabilities | | (28) | | (28) |

The fair value of interest rate contracts was determined by referring to prices quoted in the secondary market for similar contracts. Gains and losses are included in gain on sale of loans in the consolidated statements of income.

The table below presents the balance of assets measured at fair value on a nonrecurring basis as of September 30, 2014 and December 31, 2013 and the related gains and losses for the nine months ended September 30, 2014 and the year ended December 31, 2013:

| (Dollars in thousands) | | Level 1 | Level 2 | Level 3 | Total | Total Gains/ (Losses) |
|----------------------------|--|---------|---------|----------|----------|-----------------------------|
| September 30, 2014: | | | | | | |
| Impaired loans | | \$ | \$ | \$ 328 | \$ 328 | \$ (4) |
| Trust preferred securities | | | | 661 | 661 | 124 |
| December 31, 2013: | | | | | | |
| Impaired loans | | \$ | \$ | \$ 5,456 | \$ 5,456 | \$ 76 |
| Trust preferred securities | | | | 537 | 537 | 116 |

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

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

| (Dollars in thousands) | Fair Value | Valuation Technique | Unobservable Input | Value |
|---|------------|----------------------|--------------------|----------------------------|
| September 30, 2014: | | | | |
| Impaired loans non-collateral dependent | \$ 328 | Discounted cash flow | Discount rate (1) | 6.10% |
| Trust preferred securities | 661 | Discounted cash flow | Discount rate | Three-month LIBOR plus 20% |
| December 31, 2013: | | | | |
| Impaired loans non-collateral dependent | \$ 5,456 | Discounted cash flow | Discount rate (1) | 3.15% - 6.94% |
| Trust preferred securities | 537 | Discounted cash flow | Discount rate | Three-month LIBOR plus 20% |

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

(15) Subsequent Events

On October 30, 2014, the Board of Directors of Territorial Bancorp Inc. declared a quarterly cash dividend of \$0.16 per share of common stock. The dividend is expected to be paid on November 26, 2014 to stockholders of record as of November 13, 2014.

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

Cautionary Statement Regarding Forward-Looking Information

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

- statements of our goals, intentions and expectations;
- statements regarding our business plans, prospects, growth and operating strategies;

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- statements regarding the asset quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

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

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

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

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

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

Critical Accounting Policies

There are no material changes to the critical accounting policies disclosed in Territorial Bancorp Inc.'s Annual Report on Form 10-K for the year ended December 31, 2013.

Comparison of Financial Condition at September 30, 2014 and December 31, 2013

Assets. At September 30, 2014, our assets were \$1.656 billion, an increase of \$39.5 million, or 2.4%, from \$1.617 billion at December 31, 2013. The increase in assets was primarily the result of an increase in loans receivable that was partially offset by decreases in investment securities and cash.

Cash and Cash Equivalents. Cash and cash equivalents were \$64.7 million at September 30, 2014, a decrease of \$10.6 million since December 31, 2013. During the nine months ended September 30, 2014, cash was used to fund a \$69.3 million increase in total loans. In addition, the Company repurchased \$4.4 million of common stock and paid \$4.2 million of common stock dividends. This was partially offset by a \$38.5 million increase in deposits and a \$24.4 million decrease in investment securities.

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Loans. Total loans, including \$2.6 million of loans held for sale, were \$928.1 million at September 30, 2014, or 56.0% of total assets. During the nine months ended September 30, 2014, the loan portfolio increased by \$69.3 million, or 8.1%. The increase in the loan portfolio primarily occurred as the production of new one-to four-family residential loans exceeded principal repayments and loan sales.

Securities. At September 30, 2014, our securities portfolio totaled \$589.1 million, or 35.6% of total assets. During the nine months ended September 30, 2014, the securities portfolio decreased by \$24.4 million, or 4.0%. The decrease in the securities portfolio occurred as repayments and the amount of securities sold exceeded the amount of securities purchased.

At September 30, 2014, all of such securities were classified as held-to-maturity and none of the underlying collateral consisted of subprime or Alt-A (traditionally defined as nonconforming loans having less than full documentation) loans.

At September 30, 2014, we owned trust preferred securities with a carrying value of \$661,000. This portfolio consists of two securities, which represent investments in a pool of debt obligations issued by Federal Deposit Insurance Corporation-insured financial institutions, insurance companies and real estate investment trusts.

The trust preferred securities market is considered to be inactive as only five transactions have occurred over the past 33 months in the same tranche of securities that we own. We used a discounted cash flow model to determine whether these securities were other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows. We used a discount rate equal to three-month LIBOR plus 20.00% and provided a fair value estimate of \$18.65 per \$100 of par value for PreTSL XXIII.

Based on the Company's review, the Company's investment in trust preferred securities did not incur additional impairment during the quarter ended September 30, 2014.

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

Deposits. Deposits were \$1.327 billion at September 30, 2014, an increase of \$38.5 million, or 3.0%, since December 31, 2013. The growth in deposits occurred primarily in savings and checking accounts.

Borrowings. Our borrowings consist of advances from the Federal Home Loan Bank of Seattle and funds borrowed under securities sold under agreements to repurchase. During the nine months ended September 30, 2014, our borrowings remained constant at \$87.0 million. We have not required any other borrowings to fund our operations. Instead, we have primarily funded our operations with additional deposits, proceeds from loan and security sales and principal repayments on loans and mortgage-backed securities.

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Average Balances and Yields

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

| | For the Three Months Ended September 30, | | | | | |
|--|--|-----------|--------------------|-----------------------------------|-----------|--------------------|
| | 2014 | | | 2013 | | |
| | Average Outstanding Balance | Interest | Yield/ Rate (1) | Average Outstanding Balance | Interest | Yield/ Rate (1) |
| | (Dollars in thousands) | | | | | |
| Interest-earning assets: | | | | | | |
| Loans: | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential (2) | \$ 870,909 | \$ 9,448 | 4.34% | \$ 790,885 | \$ 8,750 | 4.43% |
| Multi-family residential | 5,068 | 71 | 5.60 | 5,404 | 77 | 5.70 |
| Construction, commercial and other | 20,030 | 247 | 4.93 | 13,449 | 168 | 5.00 |
| Home equity loans and lines of credit | 15,341 | 184 | 4.80 | 15,133 | 200 | 5.29 |
| Other loans | 4,824 | 70 | 5.80 | 4,818 | 72 | 5.98 |
| Total loans | 916,172 | 10,020 | 4.37 | 829,689 | 9,267 | 4.47 |
| Investment securities: | | | | | | |
| U.S. government sponsored mortgage-backed securities (2) | 600,548 | 4,895 | 3.26 | 594,898 | 4,775 | 3.21 |
| Trust preferred securities | 656 | | | 535 | | |
| Total securities | 601,204 | 4,895 | 3.26 | 595,433 | 4,775 | 3.21 |
| Other | 75,588 | 75 | 0.40 | 92,371 | 49 | 0.21 |
| Total interest-earning assets | 1,592,964 | 14,990 | 3.76 | 1,517,493 | 14,091 | 3.71 |
| Non-interest-earning assets | 65,639 | | | 62,052 | | |
| Total assets | \$ 1,658,603 | | | \$ 1,579,545 | | |
| Interest-bearing liabilities: | | | | | | |
| Savings accounts | \$ 931,040 | \$ 868 | 0.37% | \$ 890,488 | \$ 722 | 0.32% |
| Certificates of deposit | 211,426 | 263 | 0.50 | 196,151 | 302 | 0.62 |
| Money market accounts | 776 | | | 835 | | |
| Checking and Super NOW accounts | 144,190 | 7 | 0.02 | 132,251 | 7 | 0.02 |
| Total interest-bearing deposits | 1,287,432 | 1,138 | 0.35 | 1,219,725 | 1,031 | 0.34 |
| Federal Home Loan Bank advances | 15,000 | 67 | 1.79 | 15,000 | 67 | 1.79 |
| Securities sold under agreements to repurchase | 72,000 | 346 | 1.92 | 60,612 | 422 | 2.78 |
| Total interest-bearing liabilities | 1,374,432 | 1,551 | 0.45 | 1,295,337 | 1,520 | 0.47 |
| Non-interest-bearing liabilities | 67,247 | | | 65,285 | | |
| Total liabilities | 1,441,679 | | | 1,360,622 | | |
| Stockholders equity | 216,924 | | | 218,923 | | |
| Total liabilities and stockholders equity | \$ 1,658,603 | | | \$ 1,579,545 | | |
| Net interest income | | \$ 13,439 | | | \$ 12,571 | |
| Net interest rate spread (3) | | | 3.31% | | | 3.24% |
| Net interest-earning assets (4) | \$ 218,532 | | | \$ 222,156 | | |

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| | | | |
|---|---------|-------|---------|
| Net interest margin (5) | | 3.37% | 3.31% |
| Interest-earning assets to interest-bearing liabilities | 115.90% | | 117.15% |

- (1) Annualized
- (2) Average balance includes loans or investments available for sale.
- (3) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.
- (4) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
- (5) Net interest margin represents net interest income divided by average total interest-earning assets.

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| | For the Nine Months Ended September 30, | | | | | |
|--|---|-----------|--------------------|-----------------------------------|-----------|--------------------|
| | 2014 | | | 2013 | | |
| | Average Outstanding Balance | Interest | Yield/ Rate (1) | Average Outstanding Balance | Interest | Yield/ Rate (1) |
| | (Dollars in thousands) | | | | | |
| Interest-earning assets: | | | | | | |
| Loans: | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential (2) | \$ 846,210 | \$ 27,666 | 4.36% | \$ 771,725 | \$ 26,121 | 4.51% |
| Multi-family residential | 4,887 | 206 | 5.62 | 5,980 | 259 | 5.77 |
| Construction, commercial and other | 17,767 | 669 | 5.02 | 13,392 | 497 | 4.95 |
| Home equity loans and lines of credit | 15,756 | 575 | 4.87 | 14,985 | 606 | 5.39 |
| Other loans | 4,706 | 204 | 5.78 | 4,743 | 213 | 5.99 |
| Total loans | 889,326 | 29,320 | 4.40 | 810,825 | 27,696 | 4.55 |
| Investment securities: | | | | | | |
| U.S. government sponsored mortgage-backed securities (2) | 612,974 | 15,055 | 3.27 | 569,196 | 13,847 | 3.24 |
| Trust preferred securities | 617 | | | 472 | | |
| Total securities | 613,591 | 15,055 | 3.27 | 569,668 | 13,847 | 3.24 |
| Other | 76,444 | 153 | 0.27 | 132,549 | 213 | 0.21 |
| Total interest-earning assets | 1,579,361 | 44,528 | 3.76 | 1,513,042 | 41,756 | 3.68 |
| Non-interest-earning assets | 65,188 | | | 59,553 | | |
| Total assets | \$ 1,644,549 | | | \$ 1,572,595 | | |
| Interest-bearing liabilities: | | | | | | |
| Savings accounts | \$ 923,436 | \$ 2,507 | 0.36% | \$ 886,923 | \$ 2,266 | 0.34% |
| Certificates of deposit | 211,389 | 802 | 0.51 | 194,742 | 937 | 0.64 |
| Money market accounts | 817 | 1 | 0.16 | 752 | 1 | 0.18 |
| Checking and Super NOW accounts | 141,908 | 22 | 0.02 | 127,407 | 21 | 0.02 |
| Total interest-bearing deposits | 1,277,550 | 3,332 | 0.35 | 1,209,824 | 3,225 | 0.36 |
| Federal Home Loan Bank advances | 15,000 | 199 | 1.77 | 16,117 | 235 | 1.94 |
| Securities sold under agreements to repurchase | 72,000 | 1,032 | 1.91 | 64,016 | 1,370 | 2.85 |
| Total interest-bearing liabilities | 1,364,550 | 4,563 | 0.45 | 1,289,957 | 4,830 | 0.50 |
| Non-interest-bearing liabilities | 65,821 | | | 63,034 | | |
| Total liabilities | 1,430,371 | | | 1,352,991 | | |
| Stockholders equity | 214,178 | | | 219,604 | | |
| Total liabilities and stockholders equity | \$ 1,644,549 | | | \$ 1,572,595 | | |
| Net interest income | | \$ 39,965 | | | \$ 36,926 | |
| Net interest rate spread (3) | | | 3.31% | | | 3.18% |
| Net interest-earning assets (4) | \$ 214,811 | | | \$ 223,085 | | |
| Net interest margin (5) | | | 3.37% | | | 3.25% |
| Interest-earning assets to interest-bearing liabilities | 115.74% | | | 117.29% | | |

(1) Annualized

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

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

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

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Comparison of Operating Results for the Three Months Ended September 30, 2014 and 2013

General. Net income decreased by \$369,000, or 9.6%, to \$3.5 million for the three months ended September 30, 2014 compared to \$3.8 million for the three months ended September 30, 2013. The decrease in net income was primarily caused by a \$925,000 decrease in noninterest income and a \$359,000 increase in noninterest expense. This was partially offset by an \$899,000 increase in interest and dividend income.

Net Interest Income. Net interest income increased by \$868,000, or 6.9%, to \$13.4 million for the three months ended September 30, 2014 compared to \$12.6 million for the three months ended September 30, 2013. Interest and dividend income increased by \$899,000, or 6.4%, due primarily to a five basis point increase in the average yield on interest-earning assets and a \$75.5 million increase in the average balance of interest-earning assets. Interest expense increased by \$31,000, or 2.0%, due to a \$79.1 million increase in the average balance of interest-bearing liabilities that was partially offset by a two basis point decrease in the average cost of interest-bearing liabilities. The interest rate spread and net interest margin were 3.31% and 3.37%, respectively, for the three months ended September 30, 2014, compared to 3.24% and 3.31%, respectively, for the three months ended September 30, 2013.

Interest and Dividend Income. Interest and dividend income increased by \$899,000, or 6.4%, to \$15.0 million for the three months ended September 30, 2014 from \$14.1 million for the three months ended September 30, 2013. Interest income on loans increased by \$753,000, or 8.1%, to \$10.0 million for the three months ended September 30, 2014 from \$9.3 million for the three months ended September 30, 2013. The increase in interest income on loans occurred because the average balance of loans grew by \$86.5 million, or 10.4%, as new loan originations exceeded loan repayments and loan sales. The increase in interest income that occurred because of growth in the loan portfolio was partially offset by a ten basis point decline in the average loan yield to 4.37% for the three months ended September 30, 2014. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio. Interest income on investment securities increased by \$120,000, or 2.5%, to \$4.9 million for the three months ended September 30, 2014 from \$4.8 million for the three months ended September 30, 2013. The increase in interest income on securities occurred primarily because of a \$5.8 million increase in the average securities balance and a five basis point increase in the average securities yield. The increase in the average securities balance occurred as the purchase of securities exceeded repayments and the amount of securities sold. The increase in the yield on securities occurred because of a decrease in repayments that resulted in a decline in premium amortization on securities.

Interest Expense. Interest expense increased by \$31,000, or 2.0%, to \$1.6 million for the three months ended September 30, 2014 compared to \$1.5 million for the three months ended September 30, 2013. Interest expense on deposits increased by \$107,000, or 10.4%, to \$1.1 million for the three months ended September 30, 2014 compared to \$1.0 million for the three months ended September 30, 2013. The increase in interest expense on deposits occurred primarily because the average outstanding balance of deposits increased by \$67.7 million, or 5.6%, to \$1.287 billion during the three months ended September 30, 2014 compared to \$1.220 billion during the three months ended September 30, 2013. In addition, the average interest rate increased by one basis point to 0.35% during the three months ended September 30, 2014 compared to 0.34% for the three months ended September 30, 2013. The increase in interest expense on deposits was partially offset by a \$76,000, or 18.0%, decrease in interest expense on securities sold under agreements to repurchase during the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The decrease in interest expense on securities sold under agreements to repurchase was caused by an 86 basis point decrease in the average interest rate

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to 1.92% for the three months ended September 30, 2014 compared to 2.78% for the three months ended September 30, 2013. The decrease in the average rate on securities sold under agreements to repurchase was partially offset by an \$11.4 million, or 18.8%, increase in the average outstanding balance. The decrease in the average interest rate on securities sold under agreements to repurchase occurred as higher costing agreements matured and were refinanced at lower interest rates.

Provision for Loan Losses. We recorded provisions for loan losses of \$23,000 and \$45,000 for the three months ended September 30, 2014 and 2013, respectively. The net charge-offs for the three months ended September 30, 2014 and 2013 were \$5,000 and \$0, respectively. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.17% and 0.20% at September 30, 2014 and 2013, respectively. Nonaccrual loans totaled \$5.0 million at September 30, 2014, or 0.54% of total loans at that date, compared to \$5.3 million of nonaccrual loans at September 30, 2013, or 0.64% of total loans at that date. Nonaccrual loans as of September 30, 2014 and 2013 consisted primarily of one- to four-family residential real estate loans. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2014 and 2013. For additional information see footnote (6), Loans Receivable and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

Noninterest Income. The following table summarizes changes in noninterest income between the three months ended September 30, 2014 and 2013.

| | Three Months Ended | | September 30, | | Change | |
|---|--------------------|----------|---------------|------|-----------|----------|
| | 2014 | 2013 | 2014 | 2013 | \$ Change | % Change |
| | (In thousands) | | | | | |
| Service fees on loan and deposit accounts | \$ 555 | \$ 598 | \$ (43) | | (7.2)% | |
| Income on bank-owned life insurance | 265 | 295 | (30) | | (10.2)% | |
| Gain on sale of investment securities | 392 | 922 | (530) | | (57.5)% | |
| Gain on sale of loans | 118 | 365 | (247) | | (67.7)% | |
| Other | 68 | 143 | (75) | | (52.4)% | |
| Total | \$ 1,398 | \$ 2,323 | \$ (925) | | (39.8)% | |

Noninterest income decreased by \$925,000 for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. During the three months ended September 30, 2014 and 2013, we sold \$3.9 million and \$13.0 million, respectively, of held-to-maturity investment securities and recognized gains of \$392,000 and \$922,000, 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 three months ended September 30, 2014 and 2013, we also sold \$10.0 million and \$22.1 million, respectively, of mortgage loans held for sale primarily to reduce interest rate risk and recognized gains of \$118,000 and \$365,000, respectively.

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Noninterest Expense. The following table summarizes changes in noninterest expense between the three months ended September 30, 2014 and 2013.

| | Three Months Ended | | \$ Change | Change |
|---|--------------------|-----------------------|---------------|-------------|
| | 2014 | September 30, 2013 | | |
| (In thousands) | | | | |
| Salaries and employee benefits | \$ 5,402 | \$ 5,318 | \$ 84 | 1.6% |
| Occupancy | 1,474 | 1,387 | 87 | 6.3% |
| Equipment | 956 | 853 | 103 | 12.1% |
| Federal deposit insurance premiums | 202 | 193 | 9 | 4.7% |
| Other general and administrative expenses | 1,045 | 969 | 76 | 7.8% |
| Total | \$ 9,079 | \$ 8,720 | \$ 359 | 4.1% |

Noninterest expense rose by \$359,000 for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. Equipment expense increased by \$103,000 due to higher repair and maintenance, service bureau, data processing and depreciation expense. Occupancy expense increased by \$87,000 due to higher leasehold depreciation and rent expense. Salaries and employee benefits increased by \$84,000 primarily due to a decrease in the credit to compensation expense for the cost of originating new mortgage loans because of a decrease in new loan originations. The Receivables topic of the FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating loans. Other general and administrative expenses increased by \$76,000 primarily due to an increase in internal audit service and other professional fees. This was partially offset by a decrease in legal and supervisory exam fees.

Income Tax Expense. Income taxes were \$2.3 million for the three months ended September 30, 2014, reflecting an effective tax rate of 39.6% compared to \$2.3 million for the three months ended September 30, 2013, reflecting an effective tax rate of 37.5%. The increase in the effective tax rate is primarily attributed to changes in permanent tax benefits related to compensation and share-based compensation plans.

Comparison of Operating Results for the Nine Months Ended September 30, 2014 and 2013

General. Net income decreased by \$490,000, or 4.4%, to \$10.6 million for the nine months ended September 30, 2014 from \$11.1 million for the nine months ended September 30, 2013. The decrease in net income was primarily caused by a \$3.0 million decrease in noninterest income, a \$659,000 increase in noninterest expense and a \$141,000 increase in the provision for loan losses. This was partially offset by a \$2.8 million increase in interest and dividend income, a \$267,000 decrease in interest expense and a \$230,000 decrease in income taxes.

Net Interest Income. Net interest income increased by \$3.0 million, or 8.2%, to \$40.0 million for the nine months ended September 30, 2014 compared to \$36.9 million for the nine months ended September 30, 2013. Interest and dividend income increased by \$2.8 million, or 6.6%, due primarily to an eight basis point increase in the average yield on interest-earning assets and a \$66.3 million increase in the average balance of interest-earning assets. Interest expense decreased by \$267,000, or 5.5%, due to a five basis point decrease in the average cost of interest-bearing liabilities that was partially offset by a \$74.6 million increase in the average balance of interest-bearing liabilities. The interest rate spread and net interest margin were 3.31% and 3.37%, respectively, for the nine months ended September 30, 2014, compared to 3.18% and 3.25%, respectively, for the nine months ended September 30, 2013.

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Interest and Dividend Income. Interest and dividend income increased by \$2.8 million, or 6.6%, to \$44.5 million for the nine months ended September 30, 2014 from \$41.8 million for the nine months ended September 30, 2013. Interest income on loans increased by \$1.6 million, or 5.9%, to \$29.3 million for the nine months ended September 30, 2014 from \$27.7 million for the nine months ended September 30, 2013. The increase in interest income on loans occurred because the average balance of loans grew by \$78.5 million, or 9.7%, as new loan originations exceeded loan repayments and loan sales. The increase in interest income that occurred because of growth in the loan portfolio was partially offset by a 15 basis point decline in the average loan yield to 4.40% for the nine months ended September 30, 2014. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio. Interest income on investment securities increased by \$1.2 million, or 8.7%, to \$15.1 million for the nine months ended September 30, 2014 from \$13.8 million for the nine months ended September 30, 2013. The increase in interest income on securities occurred primarily because of a \$43.9 million increase in the average securities balance and a three basis point increase in the average securities yield. The increase in average securities balance occurred as the purchase of securities exceeded repayments and the amount of securities sold. The increase in the yield on securities occurred because of a decrease in repayments that resulted in a decline in the premium amortization on securities.

Interest Expense. Interest expense decreased by \$267,000, or 5.5%, to \$4.6 million for the nine months ended September 30, 2014 compared to \$4.8 million for the nine months ended September 30, 2013. Interest expense on securities sold under agreements to repurchase decreased by \$338,000, or 24.7%, during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. The decrease in interest expense on securities sold under agreements to repurchase was caused by a 94 basis point decrease in the average interest rate to 1.91% for the nine months ended September 30, 2014 compared to 2.85% for the nine months ended September 30, 2013. The decrease in the average rate on securities sold under agreements to repurchase was partially offset by an \$8.0 million, or 12.5%, increase in the average outstanding balance. The decrease in the average interest rate on securities sold under agreements to repurchase occurred as higher costing agreements matured and were refinanced at lower interest rates. Interest expense on FHLB advances decreased by \$36,000, or 15.3%, during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. The decrease was caused by a \$1.1 million, or 6.9%, decrease in the average outstanding balance and a 17 basis point decrease in the average interest rate to 1.77% for the nine months ended September 30, 2014 compared to 1.94% for the nine months ended September 30, 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 \$107,000, or 3.3%, to \$3.3 million for the nine months ended September 30, 2014 compared to \$3.2 million for the nine months ended September 30, 2013. The average outstanding balance of deposits increased by \$67.7 million, or 5.6%, to \$1.278 billion during the nine months ended September 30, 2014 compared to \$1.210 billion during the nine months ended September 30, 2013. This was offset by the decrease in average interest rate by one basis point to 0.35% during the nine months ended September 30, 2014 compared to 0.36% for the nine months ended September 30, 2013.

Provision for Loan Losses. We recorded provisions for loan losses of \$188,000 and \$47,000 for the nine months ended September 30, 2014 and 2013, respectively. The net charge-offs for the nine months ended September 30, 2014 and 2013 were \$146,000 and \$52,000, respectively. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.17% and 0.20% at September 30, 2014 and 2013, respectively. Nonaccrual loans totaled \$5.0 million at September 30, 2014, or 0.54% of total loans at that date, compared to \$5.3 million of nonaccrual loans at September 30, 2013, or 0.64% of total loans at that date. Nonaccrual loans as of September 30, 2014 and 2013 consisted primarily of one- to four-family residential real estate loans. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2014 and 2013. For additional information see footnote (6), Loans Receivable and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

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Noninterest Income. The following table summarizes changes in noninterest income between the nine months ended September 30, 2014 and 2013.

| | Nine Months Ended | | | Change | |
|---|-------------------|---------------|----|-----------|----------|
| | September 30, | September 30, | | | |
| | 2014 | 2013 | | \$ Change | % Change |
| | (In thousands) | | | | |
| Service fees on loan and deposit accounts | \$ 1,578 | \$ 1,667 | \$ | (89) | (5.3)% |
| Income on bank-owned life insurance | 797 | 774 | | 23 | 3.0% |
| Gain on sale of investment securities | 1,047 | 2,834 | | (1,787) | (63.1)% |
| Gain on sale of loans | 283 | 1,390 | | (1,107) | (79.6)% |
| Other | 330 | 329 | | 1 | 0.3% |
| Total | \$ 4,035 | \$ 6,994 | \$ | (2,959) | (42.3)% |

Noninterest income decreased by \$3.0 million for the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. During the nine months ended September 30, 2014 and 2013, we sold \$15.5 million and \$40.3 million, respectively, of held-to-maturity and trading investment securities and recognized gains of \$1.0 million and \$2.8 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 nine months ended September 30, 2014 and 2013, we also sold \$26.9 million and \$69.2 million, respectively, of mortgage loans held for sale primarily to reduce interest rate risk and recognized gains of \$283,000 and \$1.4 million, respectively.

Noninterest Expense. The following table summarizes changes in noninterest expense between the nine months ended September 30, 2014 and 2013.

| | Nine Months Ended | | | Change | |
|---|-------------------|---------------|----|-----------|----------|
| | September 30, | September 30, | | | |
| | 2014 | 2013 | | \$ Change | % Change |
| | (In thousands) | | | | |
| Salaries and employee benefits | \$ 16,062 | \$ 15,682 | \$ | 380 | 2.4% |
| Occupancy | 4,305 | 3,971 | | 334 | 8.4% |
| Equipment | 2,775 | 2,576 | | 199 | 7.7% |
| Federal deposit insurance premiums | 602 | 574 | | 28 | 4.9% |
| Other general and administrative expenses | 2,946 | 3,228 | | (282) | (8.7)% |
| Total | \$ 26,690 | \$ 26,031 | \$ | 659 | 2.5% |

Noninterest expense rose by \$659,000 for the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. Salaries and employee benefits increased by \$380,000 primarily due to a decrease in the credit to compensation expense for the cost of originating new mortgage loans because of a decrease in new loan originations. The Receivables topic of the FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating loans. Occupancy expense increased by \$334,000 due

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to higher repair and maintenance costs, depreciation and rent expense. Equipment expense increased by \$199,000 due to higher depreciation, repairs and maintenance and service bureau expense. The increases in salaries and employee benefits, occupancy and equipment expense were partially offset by a \$282,000 decrease in other general and administrative expenses due to lower legal costs and a loss on a deposit account recognized during the nine months ended September 30, 2013.

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Income Tax Expense. Income taxes were \$6.5 million for the nine months ended September 30, 2014, reflecting an effective tax rate of 37.8% compared to \$6.7 million for the nine months ended September 30, 2013, reflecting an effective tax rate of 37.6%. The increase in the effective tax rate is primarily attributed to changes in permanent tax benefits related to compensation and share-based compensation plans.

Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, cash balances at the Federal Reserve Bank, loan repayments, advances from the Federal Home Loan Bank of Seattle, securities sold under agreements to repurchase, proceeds from loan and security sales and principal repayments on securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We have established an Asset/Liability Management Committee, consisting of our President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Treasurer and our Vice President and Controller, which is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of September 30, 2014.

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

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

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

Our most liquid asset is cash. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2014, cash and cash equivalents totaled \$64.7 million. On that date, we had \$72.0 million in securities sold under agreements to repurchase outstanding and \$15.0 million of Federal Home Loan Bank advances outstanding, with the ability to borrow an additional \$396.9 million under Federal Home Loan Bank advances.

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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.

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At September 30, 2014, we had \$16.5 million in loan commitments outstanding, most of which were for fixed-rate loans, and had \$24.3 million in unused lines of credit to borrowers. Certificates of deposit due within one year at September 30, 2014 totaled \$162.5 million, or 12.2% of total deposits. If these deposits do not remain with us, we may be required to seek other sources of funds, including loan sales, brokered deposits, securities sold under agreements to repurchase and Federal Home Loan Bank advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before September 30, 2015. 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 nine months ended September 30, 2014 and 2013, we originated \$168.6 million and \$240.5 million of loans, respectively, and purchased \$39.9 million and \$240.5 million of securities, respectively.

Financing activities consist primarily of activity in deposit accounts, Federal Home Loan Bank advances and securities sold under agreements to repurchase. We experienced a net increase in deposits of \$38.5 million and \$20.5 million for the nine months ended September 30, 2014 and 2013, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the Federal Home Loan Bank of Seattle, which provide an additional source of funds. Federal Home Loan Bank advances remained constant at \$15.0 million during the nine months ended September 30, 2014 and decreased by \$5.0 million during the nine months ended September 30, 2013. We had the ability to borrow up to an additional \$396.9 million and \$375.6 million from the Federal Home Loan Bank of Seattle as of September 30, 2014 and 2013, respectively. We also utilize securities sold under agreements to repurchase as another borrowing source. Securities sold under agreements to repurchase remained constant at \$72.0 million for the nine months ended September 30, 2014 and decreased by \$23.0 million for the nine months ended September 30, 2013.

Territorial Savings Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. On July 10, 2014, Territorial Savings Bank became a member of the Federal Reserve System. The Federal Reserve requires that the Bank maintain a Tier 1 Leverage Capital ratio of 9.0% for the next three years as a condition of membership. At September 30, 2014, Territorial Savings Bank exceeded all regulatory capital requirements. Territorial Savings Bank is considered well capitalized under regulatory guidelines. The tables below present the capital required as a percentage of total and risk-weighted assets and the percentage and the total amount of capital maintained at September 30, 2014 and December 31, 2013.

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As of September 30, 2014

(Dollars in thousands)

| | Required | | Territorial Savings Bank | |
|---------------------------|-----------------|----|---------------------------------|--------|
| Tier 1 Leverage Capital | 9% | \$ | 213,301 | 12.85% |
| Total Risk-Based Capital | 8% | \$ | 214,835 | 32.35% |
| Tier 1 Risk-Based Capital | 4% | \$ | 213,301 | 32.12% |

As of December 31, 2013

(Dollars in thousands)

| | Required | | Territorial Savings Bank | |
|---------------------------|-----------------|----|---------------------------------|--------|
| Tier 1 Leverage Capital | 4% | \$ | 200,074 | 12.35% |
| Total Risk-Based Capital | 8% | \$ | 201,566 | 31.99% |
| Tier 1 Risk-Based Capital | 4% | \$ | 200,074 | 31.75% |

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

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

Contractual Obligations. In the ordinary course of our operations, we enter into certain contractual obligations. Such obligations include operating leases for premises and equipment, agreements with respect to borrowed funds and deposit liabilities and agreements with respect to investments. Except for an increase of \$2.4 million in certificates of deposit between December 31, 2013 and September 30, 2014, there have not been any material changes in contractual obligations and funding needs since December 31, 2013.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

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

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

The following table presents our internal calculations of the estimated changes in our EVE as of June 30, 2014 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 | \$ 184,888 | \$ (91,739) | (33.16)% | 11.43% | (4.65)% |
| +300 | \$ 209,089 | \$ (67,538) | (24.41)% | 12.72% | (3.36)% |

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| | | | | | | | |
|------|----|---------|----|----------|----------|--------|---------|
| +200 | \$ | 238,502 | \$ | (38,125) | (13.78)% | 14.23% | (1.85)% |
| +100 | \$ | 264,012 | \$ | (12,615) | (4.56)% | 15.49% | (0.59)% |
| 0 | \$ | 276,627 | \$ | | % | 16.08% | % |
| -100 | \$ | 262,101 | \$ | (14,526) | (5.25)% | 15.35% | (0.73)% |

-
- (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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Interest rates on mortgage-backed securities declined by approximately four basis points between June 30, 2014 and September 30, 2014. The decrease in interest rates has likely increased our EVE. However, we do not believe that the increase in EVE is material.

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

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Treasurer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 30, 2014. Based on that evaluation, because of the material weaknesses in internal control over financial reporting described in the Company's Annual Report on Form 10-K for the Year Ended December 31, 2013, the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Treasurer, concluded that the Company's disclosure controls and procedures were not effective.

Except as set forth below, there have been no changes in the Company's internal controls over financial reporting that occurred during the period covered by this report that have materially affected or are reasonably likely to materially affect, the Company's internal control over financial reporting. Following management's conclusion as to material weaknesses in internal controls over financial reporting as of December 31, 2013, management has taken the following remedial actions.

- The Company is working with a consultant to develop a risk assessment for the effective identification of financial reporting risks and controls.
- The Company is in the process of implementing the following controls relative to the deficiencies in investment securities policies and processes:
 - The Company established controls in April 2014 over the completeness and accuracy of vendor pricing used to value the held to maturity securities portfolio. The Company uses two sources to price its investment securities. There are controls on both of these sources for the reliable collection and transmission of investment pricing data.

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- Additional controls were added in April 2014 to provide for an independent review of information entered into the securities system.
- A review by a qualified person not involved in preparing the initial evaluation of the Company's evaluation of the impairment of Federal Home Loan Bank stock was established in April 2014.
- In April 2014, the Company adjusted the design of the control over the reconciliation of the investment system to the reports from the securities custodian such that the reconciliation is performed by an individual who is not responsible for entry of information into the investment system. This change provided for appropriate segregation of duties.
- The Company is in the process of implementing the following controls related to income tax policies and procedures:
 - The income tax provision since April 2014 was prepared by the Controller and reviewed by the Treasurer. The Treasurer's review of the income tax provision included a detailed verification of inputs and calculations as well as detailed documentation on how the provision was reviewed.
 - The reconciliation of the income tax return to the tax provision is performed annually in the fourth quarter of each year. The next reconciliation will be performed in the fourth quarter of 2014. This reconciliation will be prepared by one person and reviewed by a second party.
 - The effective tax calculation since April 2014 was prepared by the Controller and reviewed by the Treasurer. The Treasurer's review of the effective tax calculation included a verification of inputs and calculations as well as detailed documentation on how the calculation was reviewed.

Management anticipates that these remedial actions will strengthen the Company's internal controls over financial reporting and will, over time, address the material weaknesses that were identified as of December 31, 2013. Since some of these remedial actions will take place on a quarterly basis, their successful implementation may need to be evaluated over several quarters before management is able to conclude that the underlying material weakness has been remediated.

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PART II

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

There have been no material changes from Risk Factors as previously disclosed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission for the period ended December 31, 2013.

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

(a) Not applicable.

(b) Not applicable.

(c) Stock Repurchases. The following table sets forth information in connection with repurchases of our shares of common stock during the third quarter of 2014:

| 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 |
|--|----------------------------------|------------------------------|--|--|
| August 1, 2014 through August 31, 2014 (1) | 24,115 | \$ 20.53 | | |

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(1) Represents shares repurchased to cover tax withholding related to restricted stock vesting.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

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SIGNATURES

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

TERRITORIAL BANCORP INC.
(Registrant)

Date: November 7, 2014

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

Date: November 7, 2014

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

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INDEX TO EXHIBITS

**Exhibit
Number**

Description

