

Territorial Bancorp Inc.  
Form 10-Q  
November 08, 2012  
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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, 2012

or

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

For transition period from            to

Commission File Number 1-34403

**TERRITORIAL BANCORP INC.**

(Exact Name of Registrant as Specified in Charter)

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

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

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

**96813**  
(Zip Code)

**(808) 946-1400**

Registrant's telephone number, including area code

**Not Applicable**

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

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

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

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

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

10,901,705 shares of Common Stock, par value \$0.01 per share, were issued and outstanding as of October 31, 2012.

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**TERRITORIAL BANCORP INC.**

Form 10-Q Quarterly Report

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

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and cash equivalents   | \$ 155,265            | \$ 131,937           |
| Investment securities held to maturity, at amortized cost (fair value of \$633,513 and \$687,319 at September 30, 2012 and December 31, 2011, respectively)                     | 595,607               | 653,871              |
| Federal Home Loan Bank stock, at cost   | 12,238                | 12,348               |
| Loans held for sale   | 4,032                 | 3,231                |
| Loans receivable, net   | 746,874               | 688,095              |
| Accrued interest receivable   | 4,676                 | 4,780                |
| Premises and equipment, net   | 5,082                 | 5,450                |
| Real estate owned   | 176                   | 408                  |
| Bank-owned life insurance   | 30,940                | 30,234               |
| Deferred income taxes receivable  | 3,035                 | 2,648                |
| Prepaid expenses and other assets   | 4,755                 | 4,569                |
| <b>Total assets</b>   | <b>\$ 1,562,680</b>   | <b>\$ 1,537,571</b>  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                       |                      |
| <b>Liabilities:</b>   |                       |                      |
| Deposits  | \$ 1,226,527          | \$ 1,166,116         |
| Advances from the Federal Home Loan Bank  | 20,000                | 20,000               |
| Securities sold under agreements to repurchase  | 70,000                | 108,300              |
| Investment purchases pending settlement   | 1,136                 | 0                    |
| Accounts payable and accrued expenses   | 23,158                | 22,816               |
| Current income taxes payable  | 147                   | 3,114                |
| Advance payments by borrowers for taxes and insurance   | 2,295                 | 3,264                |
| <b>Total liabilities</b>  | <b>1,343,263</b>      | <b>1,323,610</b>     |
| <b>Stockholders Equity:</b>   |                       |                      |
| Preferred stock, \$.01 par value; authorized 50,000,000 shares, no shares issued or outstanding   | 0                     | 0                    |
| Common stock, \$.01 par value; authorized 100,000,000 shares; issued and outstanding 10,901,705 and 11,022,309 shares at September 30, 2012 and December 31, 2011, respectively | 109                   | 110                  |
| Additional paid-in capital  | 94,920                | 97,640               |
| Unearned ESOP shares  | (7,952)               | (8,319)              |
| Retained earnings   | 135,915               | 128,300              |
| Accumulated other comprehensive loss  | (3,575)               | (3,770)              |

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|  |              |              |
|--|--------------|--------------|
| Total stockholders' equity                 | 219,417      | 213,961      |
| Total liabilities and stockholders' equity | \$ 1,562,680 | \$ 1,537,571 |

See accompanying notes to consolidated financial statements.

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

|  | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2012                                | 2011          | 2012                               | 2011          |
| <b>Interest and dividend income:</b>                       |                                     |               |                                    |               |
| Investment securities                                      | \$ 5,551                            | \$ 6,907      | \$ 18,360                          | \$ 20,167     |
| Loans  | 9,187                               | 8,798         | 27,326                             | 26,444        |
| Other investments  | 88                                  | 85            | 259                                | 258           |
| <b>Total interest and dividend income</b>                  | <b>14,826</b>                       | <b>15,790</b> | <b>45,945</b>                      | <b>46,869</b> |
| <b>Interest expense:</b>                                   |                                     |               |                                    |               |
| Deposits   | 1,492                               | 1,700         | 4,644                              | 5,109         |
| Advances from the Federal Home Loan Bank                   | 105                                 | 105           | 313                                | 295           |
| Securities sold under agreements to repurchase             | 629                                 | 1,067         | 2,364                              | 3,153         |
| <b>Total interest expense</b>                              | <b>2,226</b>                        | <b>2,872</b>  | <b>7,321</b>                       | <b>8,557</b>  |
| <b>Net interest income</b>                                 | <b>12,600</b>                       | <b>12,918</b> | <b>38,624</b>                      | <b>38,312</b> |
| Provision (reversal of allowance) for loan losses          | 167                                 | (39)          | 172                                | 83            |
| <b>Net interest income after provision for loan losses</b> | <b>12,433</b>                       | <b>12,957</b> | <b>38,452</b>                      | <b>38,229</b> |
| <b>Noninterest income:</b>                                 |                                     |               |                                    |               |
| Service fees on loan and deposit accounts                  | 444                                 | 534           | 1,474                              | 1,690         |
| Income on bank-owned life insurance                        | 239                                 | 245           | 706                                | 725           |
| Gain on sale of investment securities                      | 429                                 | 74            | 729                                | 140           |
| Gain on sale of loans                                      | 669                                 | 138           | 1,516                              | 374           |
| Other  | 141                                 | 177           | 346                                | 588           |
| <b>Total noninterest income</b>                            | <b>1,922</b>                        | <b>1,168</b>  | <b>4,771</b>                       | <b>3,517</b>  |
| <b>Noninterest expense:</b>                                |                                     |               |                                    |               |
| Salaries and employee benefits                             | 5,202                               | 6,017         | 15,416                             | 16,630        |
| Occupancy  | 1,316                               | 1,267         | 3,930                              | 3,714         |
| Equipment  | 800                                 | 792           | 2,423                              | 2,366         |
| Federal deposit insurance premiums                         | 192                                 | 191           | 574                                | 678           |
| Loss on extinguishment of debt                             | 123                                 | 0             | 321                                | 0             |
| Other general and administrative expenses                  | 964                                 | 954           | 3,069                              | 2,887         |
| <b>Total noninterest expense</b>                           | <b>8,597</b>                        | <b>9,221</b>  | <b>25,733</b>                      | <b>26,275</b> |
| <b>Income before income taxes</b>                          | <b>5,758</b>                        | <b>4,904</b>  | <b>17,490</b>                      | <b>15,471</b> |
| Income taxes   | 2,111                               | 1,918         | 6,457                              | 6,100         |

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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Net income   | \$ 3,647   | \$ 2,986   | \$ 11,033  | \$ 9,371   |
| Basic earnings per share                                     | \$ 0.36    | \$ 0.28    | \$ 1.09    | \$ 0.85    |
| Diluted earnings per share                                   | \$ 0.36    | \$ 0.28    | \$ 1.08    | \$ 0.84    |
| Cash dividends declared per common share                     | \$ 0.11    | \$ 0.09    | \$ 0.32    | \$ 0.25    |
| Basic weighted-average shares outstanding                    | 10,052,630 | 10,659,532 | 10,126,371 | 10,969,320 |
| Diluted weighted-average shares outstanding                  | 10,199,400 | 10,835,649 | 10,205,408 | 11,117,444 |
| See accompanying notes to consolidated financial statements. |            |            |            |            |

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**TERRITORIAL BANCORP INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income (Unaudited)**

**(Dollars in thousands)**

|   | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2012</b>                                 | <b>2011</b> | <b>2012</b>                                | <b>2011</b> |
| Net income  | \$ 3,647                                    | \$ 2,986    | \$ 11,033                                  | \$ 9,371    |
| Change in unrealized loss on securities                                     | 8   | 2           | 18   | 189         |
| Reduction of noncredit related losses on securities not expected to be sold | 177   | 0           | 177  | 0           |
| Other comprehensive income  | 185   | 2           | 195  | 189         |
| Comprehensive income  | \$ 3,832                                    | \$ 2,988    | \$ 11,228                                  | \$ 9,560    |

See accompanying notes to consolidated financial statements.



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

(Dollars in thousands)

|  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>(Loss)/Income | Total<br>Stockholders<br>Equity |
|--|-----------------|----------------------------------|----------------------------|----------------------|--|---------------------------------|
| Balances at December 31, 2010                          | \$ 122          | \$ 119,153                       | \$ (8,808)                 | \$ 119,397           | \$ (2,505)   | \$ 227,359                      |
| Net income   | 0               | 0                                | 0                          | 9,371                | 0  | 9,371                           |
| Other comprehensive income                             | 0               | 0                                | 0                          | 0                    | 189  | 189                             |
| Cash dividends declared                                | 0               | 0                                | 0                          | (2,746)              | 0  | (2,746)                         |
| Share-based compensation                               | 1               | 2,790                            | 0                          | 0                    | 0  | 2,791                           |
| Allocation of 36,699 ESOP shares                       | 0               | 362                              | 367                        | 0                    | 0  | 729                             |
| Repurchase of 1,202,471 shares of company common stock | (12)            | (23,463)                         | 0                          | 0                    | 0  | (23,475)                        |
| Balances at September 30, 2011                         | \$ 111          | \$ 98,842                        | \$ (8,441)                 | \$ 126,022           | \$ (2,316)   | \$ 214,218                      |
| Balances at December 31, 2011                          | \$ 110          | \$ 97,640                        | \$ (8,319)                 | \$ 128,300           | \$ (3,770)   | \$ 213,961                      |
| Net income   | 0               | 0                                | 0                          | 11,033               | 0  | 11,033                          |
| Other comprehensive income                             | 0               | 0                                | 0                          | 0                    | 195  | 195                             |
| Cash dividends declared                                | 0               | 0                                | 0                          | (3,418)              | 0  | (3,418)                         |
| Share-based compensation                               | 1               | 2,016                            | 0                          | 0                    | 0  | 2,017                           |
| Allocation of 36,699 ESOP shares                       | 0               | 438                              | 367                        | 0                    | 0  | 805                             |
| Repurchase of 275,186 shares of company common stock   | (2)             | (5,890)                          | 0                          | 0                    | 0  | (5,892)                         |
| Exercise of 41,275 options on common stock             | 0               | 716                              | 0                          | 0                    | 0  | 716                             |
| Balances at September 30, 2012                         | \$ 109          | \$ 94,920                        | \$ (7,952)                 | \$ 135,915           | \$ (3,575)   | \$ 219,417                      |

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<br>September 30, |                  |
|---|------------------------------------|------------------|
|   | 2012                               | 2011             |
| <b>Cash flows from operating activities:</b>                                      |                                    |                  |
| Net income  | \$ 11,033                          | \$ 9,371         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |                  |
| Provision for loan losses   | 172                                | 83               |
| Depreciation and amortization   | 852                                | 835              |
| Deferred income tax benefit   | (516)                              | (1,126)          |
| Amortization of fees, discounts, and premiums                                     | 53                                 | (44)             |
| Origination of loans held for sale  | (75,184)                           | (34,600)         |
| Proceeds from sales of loans held for sale  | 75,899                             | 35,221           |
| Gain on sale of loans, net  | (1,516)                            | (374)            |
| Net gain on sale of real estate owned   | (43)                               | 0                |
| Purchases of investment securities held for trading                               | 0                                  | (36,171)         |
| Proceeds from sale of investment securities held for trading                      | 0                                  | 36,311           |
| Gain on sale of investment securities held for trading                            | 0                                  | (140)            |
| Gain on sale of investment securities held to maturity                            | (729)                              | 0                |
| Net gain on sale of premises and equipment  | 0                                  | (5)              |
| ESOP expense  | 805                                | 729              |
| Share-based compensation expense  | 2,016                              | 2,791            |
| Excess tax benefits from share-based compensation                                 | (54)                               | 0                |
| (Increase) decrease in accrued interest receivable                                | 104                                | (346)            |
| Net increase in bank-owned life insurance   | (706)                              | (725)            |
| Net (increase) decrease in prepaid expenses and other assets                      | (186)                              | 1,543            |
| Net increase (decrease) in accounts payable and accrued expenses                  | 342                                | (703)            |
| Net decrease in income taxes payable  | (2,967)                            | (161)            |
| <b>Net cash provided by operating activities</b>                                  | <b>9,375</b>                       | <b>12,489</b>    |
| <b>Cash flows from investing activities:</b>                                      |                                    |                  |
| Purchases of investment securities held to maturity                               | (111,467)                          | (211,257)        |
| Principal repayments on investment securities held to maturity                    | 160,668                            | 97,289           |
| Principal repayments on investment securities available for sale                  | 0                                  | 525              |
| Proceeds from sale of investment securities held to maturity                      | 9,983                              | 0                |
| Loan originations, net of principal repayments on loans receivable                | (57,911)                           | (20,403)         |
| Proceeds from redemption of Federal Home Loan Bank stock                          | 110                                | 0                |
| Proceeds from sale of real estate owned   | 451                                | 0                |
| Proceeds from disposals of premises and equipment                                 | 0                                  | 5                |
| Purchases of premises and equipment   | (484)                              | (973)            |
| <b>Net cash (used in) provided by investing activities</b>                        | <b>1,350</b>                       | <b>(134,814)</b> |

(Continued)



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

(Dollars in thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2012</b>                                | <b>2011</b> |
| <b>Cash flows from financing activities:</b>                          |  |             |
| Net increase in deposits  | \$ 60,411                                  | \$ 62,847   |
| Proceeds from advances from the Federal Home Loan Bank                | 100  | 10,000      |
| Repayments of advances from the Federal Home Loan Bank                | (100)                                      | 0           |
| Proceeds from securities sold under agreements to repurchase          | 0  | 47,000      |
| Repayments of securities sold under agreements to repurchase          | (38,300)                                   | (32,000)    |
| Purchases of Fed Funds  | 10   | 10          |
| Sales of Fed Funds  | (10)                                       | (10)        |
| Net decrease in advance payments by borrowers for taxes and insurance | (969)                                      | (1,288)     |
| Excess tax benefits from share-based compensation                     | 54   | 0           |
| Proceeds from issuance of common stock                                | 717  | 0           |
| Repurchases of company stock  | (5,892)                                    | (23,475)    |
| Cash dividends paid   | (3,418)                                    | (2,746)     |
| Net cash provided by financing activities                             | 12,603                                     | 60,338      |
| Net increase (decrease) in cash and cash equivalents                  | 23,328                                     | (61,987)    |
| Cash and cash equivalents at beginning of the period                  | 131,937                                    | 194,435     |
| Cash and cash equivalents at end of the period                        | \$ 155,265                                 | \$ 132,448  |
| Supplemental disclosure of cash flow information:                     |  |             |
| Cash paid for:  |  |             |
| Interest on deposits and borrowings                                   | \$ 7,478                                   | \$ 8,531    |
| Income taxes  | 9,940                                      | 7,388       |
| Supplemental disclosure of noncash investing activities:              |  |             |
| Loans transferred to real estate owned                                | \$ 176                                     | \$ 162      |
| Investments purchased, not settled                                    | 1,136                                      | 0           |
| See accompanying notes to consolidated financial statements.          |  |             |

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**TERRITORIAL BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**(1) Basis of Presentation**

The accompanying unaudited consolidated financial statements of Territorial Bancorp Inc. have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. These interim condensed consolidated financial statements and notes should be read in conjunction with Territorial Bancorp Inc.'s consolidated financial statements and notes thereto filed as part of the Annual Report on Form 10-K for the year ended December 31, 2011. In the opinion of management, all adjustments necessary for a fair presentation have been made and include all normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year.

**(2) Organization**

On November 4, 2008, the Board of Directors of Territorial Mutual Holding Company approved a plan of conversion and reorganization under which the Company would convert from a mutual holding company to a stock holding company. The conversion to a stock holding company was approved by the depositors and borrowers of Territorial Savings Bank and the Office of Thrift Supervision (OTS) and included the filing of a registration statement with the U.S. Securities and Exchange Commission. Upon the completion of the conversion and reorganization on July 10, 2009, Territorial Mutual Holding Company and Territorial Savings Group, Inc. ceased to exist as separate legal entities and Territorial Bancorp Inc. became the holding company for Territorial Savings Bank. A total of 12,233,125 shares were issued in the conversion at \$10 per share, raising \$122.3 million of gross proceeds. \$3.7 million of conversion expenses have been offset against the gross proceeds. Territorial Bancorp Inc.'s common stock began trading on the NASDAQ Global Select Market under the symbol TBNK on July 13, 2009.

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

**(3) Recently Adopted Accounting Pronouncements**

In April 2011, the Financial Accounting Standards Board (FASB) amended the Transfers and Servicing topic of the FASB Accounting Standards Codification (ASC). The amendment modified the criteria used to determine whether a repurchase agreement is accounted for as a sale or as a secured borrowing. The amendment was effective for interim or annual periods beginning on or after December 15, 2011. Early adoption was not permitted. The Company adopted this amendment on January 1, 2012, and the adoption did not have any effect on its consolidated financial statements.

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In May 2011, the FASB amended the Fair Value Measurement topic of the FASB ASC. The amendment results in common fair value measurement and disclosure requirements in U.S. generally accepted accounting principles and International Financial Reporting Standards. The amendment both clarifies the intent about existing fair value measurements as well as changed the principle or requirement for measuring fair value or disclosing fair value information. The amendment was effective for interim or annual periods beginning after December 15, 2011. Early application was not permitted. The Company adopted this amendment on January 1, 2012, and the adoption did not have a material effect on its consolidated financial statements.

In June 2011, the FASB amended the Comprehensive Income topic of the FASB ASC. The amendment eliminated the option of presenting components of other comprehensive income as part of the statement of changes in stockholders' equity. Nonowner changes in stockholders' equity must be presented either in a continuous statement of comprehensive income or in two separate but consecutive statements. The amendment was effective for interim or annual periods beginning after December 15, 2011, with early adoption permitted. In December 2011, the FASB deferred the effective date of the part of this amendment requiring reclassifications out of accumulated other comprehensive income to be shown on the face of the financial statements. Pending a final decision on this issue by the FASB, previous disclosure requirements will remain in effect. The Company adopted this amendment on January 1, 2012, and other than the location of disclosures related to other comprehensive income, the adoption did not have a material effect on its consolidated financial statements.

In December 2011, the FASB amended the Balance Sheet topic of the FASB ASC. The amendment requires disclosures about the gross and net information related to instruments and transactions eligible for offset in the statement of financial position. The disclosures are meant to assist users of financial statements to more easily compare information that is presented based on the differing offsetting requirements of U.S. generally accepted accounting principles and International Financial Reporting Standards. The amendment is effective for interim and annual periods beginning on or after January 1, 2013. The Company does not expect the adoption of this amendment to have a material effect on its consolidated financial statements.

**(4) Cash and Cash Equivalents**

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

| (Dollars in thousands)                   | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
| Cash and due from banks                  | \$ 12,634             | \$ 8,692             |
| Interest-earning deposits in other banks | 142,631               | 123,245              |
| <b>Cash and cash equivalents</b>         | <b>\$ 155,265</b>     | <b>\$ 131,937</b>    |

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**(5) Investment Securities**

The carrying and fair values of investment securities are as follows:

| (Dollars in thousands)                               | Carrying value    | Gross unrealized Gains | Losses          | Estimated fair value |
|--|-------------------|------------------------|-----------------|----------------------|
| <b>September 30, 2012:</b>                           |                   |                        |                 |                      |
| Held to maturity:                                    |                   |                        |                 |                      |
| U.S. government-sponsored mortgage-backed securities | \$ 595,281        | \$ 38,189              | \$ (283)        | \$ 633,187           |
| Trust preferred securities                           | 326               | 0                      | 0               | 326                  |
| <b>Total</b>   | <b>\$ 595,607</b> | <b>\$ 38,189</b>       | <b>\$ (283)</b> | <b>\$ 633,513</b>    |
| <b>December 31, 2011:</b>                            |                   |                        |                 |                      |
| Held to maturity:                                    |                   |                        |                 |                      |
| U.S. government-sponsored mortgage-backed securities | \$ 653,839        | \$ 33,490              | \$ (269)        | \$ 687,060           |
| Trust preferred securities                           | 32                | 227                    | 0               | 259                  |
| <b>Total</b>   | <b>\$ 653,871</b> | <b>\$ 33,717</b>       | <b>\$ (269)</b> | <b>\$ 687,319</b>    |

The carrying value and estimated fair value of investment securities at September 30, 2012 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 after 5 years through 10 years | \$ 4,193          | \$ 4,279             |
| Due after 10 years                 | 591,414           | 629,234              |
| <b>Total</b>                       | <b>\$ 595,607</b> | <b>\$ 633,513</b>    |

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

| (Dollars in thousands) | Three months ended<br>September 30, |           | Nine months ended<br>September 30, |           |
|------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                        | 2012                                | 2011      | 2012                               | 2011      |
| Proceeds from sales    | \$ 5,424                            | \$ 16,445 | \$ 9,983                           | \$ 36,311 |
| Gross gains            | 429                                 | 74        | 729                                | 140       |
| Gross losses           | 0                                   | 0         | 0                                  | 0         |

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During the three months ended September 30, 2012, all sales were related to \$5.0 million of held-to-maturity debt securities. During the nine months ended September 30, 2012, all sales were related to \$9.3 million of held-to-maturity debt securities. The sale of these securities, for which the Company had already collected a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio. There were no sales of held-to-maturity securities during the three months or nine months ended September 30, 2011.

Investment securities with carrying values of \$238.0 million and \$281.0 million at September 30, 2012 and December 31, 2011, 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, 2012 and December 31, 2011. 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<br>(Dollars in thousands) | Less than 12 months |                   | 12 months or longer |                   | Number of securities | Total      |                   |
|---|---------------------|-------------------|---------------------|-------------------|----------------------|------------|-------------------|
|   | Fair value          | Unrealized losses | Fair value          | Unrealized losses |                      | Fair value | Unrealized losses |
| <b>September 30, 2012:</b>                          |                     |                   |                     |                   |                      |            |                   |
| Mortgage-backed securities                          | \$ 10,793           | \$ 282            | \$ 60               | \$ 1              | 13                   | \$ 10,853  | \$ 283            |
| <b>December 31, 2011:</b>                           |                     |                   |                     |                   |                      |            |                   |
| Mortgage-backed securities                          | \$ 17,697           | \$ 268            | \$ 122              | \$ 1              | 7                    | \$ 17,819  | \$ 269            |

**Trust Preferred Securities.** At September 30, 2012, the Company owns two trust preferred securities, PreTSL XXIII and XXIV. PreTSL XXIV has a carrying value and amortized cost basis of \$0. PreTSL XXIII has a carrying value of \$326,000 and an amortized cost basis of \$1.1 million. For PreTSL XXIII, the difference between the carrying value of \$326,000 and the remaining amortized cost basis of \$1.1 million is included as a component of accumulated other comprehensive loss, net of taxes, and is related to noncredit factors such as the trust preferred securities market being inactive. The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. These securities are classified in the Bank's held-to-maturity investment portfolio.

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

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, 2012 as the present value of cash flows exceeded the amortized cost basis of \$1.1 million.

At September 30, 2012, PreTSL XXIII and XXIV are rated C by Fitch.

It is reasonably possible that the fair values of the trust preferred securities could decline in the near term if the overall economy and the financial condition of some of the issuers continue to deteriorate



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and the liquidity of these securities remains low. As a result, there is a risk that the Company's amortized cost basis of \$1.1 million on its trust preferred securities could be other-than-temporarily impaired in the near term. The impairment could be material to the Company's consolidated statements of income.

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

| (Dollars in thousands)   | 2012     | 2011     |
|--|----------|----------|
| Balance at January 1   | \$ 5,885 | \$ 5,885 |
| Credit losses on debt securities for which other-than-temporary impairment was not previously recognized | 0        | 0        |
| Balance at September 30  | \$ 5,885 | \$ 5,885 |

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

| (Dollars in thousands)   | September 30, 2012 | September 30, 2011 |
|--|--------------------|--------------------|
| Noncredit losses on other-than-temporarily impaired securities | \$ 502             | \$ 679             |

**(6) Loans Receivable and Allowance for Loan Losses**

The components of loans receivable are as follows:

| (Dollars in thousands)                | September 30, 2012 | December 31, 2011 |
|---------------------------------------|--------------------|-------------------|
| <b>Real estate loans:</b>             |                    |                   |
| First mortgages:                      |                    |                   |
| One- to four-family residential       | \$ 715,026         | \$ 654,412        |
| Multi-family residential              | 6,800              | 6,956             |
| Construction, commercial, and other   | 11,882             | 11,140            |
| Home equity loans and lines of credit | 15,120             | 17,253            |
| <b>Total real estate loans</b>        | <b>748,828</b>     | <b>689,761</b>    |
| <b>Other loans:</b>                   |                    |                   |
| Loans on deposit accounts             | 482                | 756               |
| Consumer and other loans              | 4,288              | 4,732             |
| <b>Total other loans</b>              | <b>4,770</b>       | <b>5,488</b>      |
| <b>Less:</b>                          |                    |                   |
| Net unearned fees and discounts       | (5,229)            | (5,613)           |
| Allowance for loan losses             | (1,495)            | (1,541)           |

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|                       |            |            |
|-----------------------|------------|------------|
|                       | (6,724)    | (7,154)    |
| Loans receivable, net | \$ 746,874 | \$ 688,095 |

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

| (Dollars in thousands)                            | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|---|-------------|--|-------------|
|   | <b>2012</b>                                 | <b>2011</b> | <b>2012</b>                                | <b>2011</b> |
| Balance, beginning of period                      | \$ 1,457                                    | \$ 1,592    | \$ 1,541                                   | \$ 1,488    |
| Provision (reversal of allowance) for loan losses | 167   | (39)        | 172  | 83          |
|   | 1,624                                       | 1,553       | 1,713                                      | 1,571       |
| Charge-offs                                       | (137)                                       | (7)         | (273)                                      | (62)        |
| Recoveries  | 8   | 6           | 55   | 43          |
| Net charge-offs                                   | (129)                                       | (1)         | (218)                                      | (19)        |
| Balance, end of period                            | \$ 1,495                                    | \$ 1,552    | \$ 1,495                                   | \$ 1,552    |

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

| (Dollars in thousands)                            | <b>Residential<br/>Mortgage</b> | <b>Construction,<br/>Commercial<br/>and Other<br/>Mortgage<br/>Loans</b> | <b>Home<br/>Equity<br/>Loans and<br/>Lines of<br/>Credit</b> | <b>Consumer<br/>and Other</b> | <b>Unallocated</b> | <b>Totals</b> |
|---|---------------------------------|--|--|-------------------------------|--------------------|---------------|
| <b>Three months ended September 30, 2012:</b>     |                                 |  |  |                               |                    |               |
| Balance, beginning of period                      | \$ 552                          | \$ 641   | \$ 35  | \$ 107                        | \$ 122             | \$ 1,457      |
| Provision for loan losses                         | 157                             | 0  | 2  | 8                             | 0                  | 167           |
|   | 709                             | 641  | 37   | 115                           | 122                | 1,624         |
| Charge-offs                                       | (125)                           | 0  | (2)  | (10)                          | 0                  | (137)         |
| Recoveries  | 6                               | 0  | 0  | 2                             | 0                  | 8             |
| Net charge-offs                                   | (119)                           | 0  | (2)  | (8)                           | 0                  | (129)         |
| Balance, end of period                            | \$ 590                          | \$ 641   | \$ 35  | \$ 107                        | \$ 122             | \$ 1,495      |
| <b>Nine months ended September 30, 2012:</b>      |                                 |  |  |                               |                    |               |
| Balance, beginning of period                      | \$ 631                          | \$ 285   | \$ 258   | \$ 291                        | \$ 76              | \$ 1,541      |
| Provision (reversal of allowance) for loan losses | 151                             | 364  | (222)  | (167)                         | 46                 | 172           |
|   | 782                             | 649  | 36   | 124                           | 122                | 1,713         |
| Charge-offs                                       | (233)                           | (8)  | (3)  | (29)                          | 0                  | (273)         |
| Recoveries  | 41                              | 0  | 2  | 12                            | 0                  | 55            |
| Net charge-offs                                   | (192)                           | (8)  | (1)  | (17)                          | 0                  | (218)         |

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|                        |    |     |    |     |    |    |    |     |    |     |    |       |
|------------------------|----|-----|----|-----|----|----|----|-----|----|-----|----|-------|
| Balance, end of period | \$ | 590 | \$ | 641 | \$ | 35 | \$ | 107 | \$ | 122 | \$ | 1,495 |
|------------------------|----|-----|----|-----|----|----|----|-----|----|-----|----|-------|

Beginning with the quarter ended March 31, 2012, the Company enhanced its methodology for reviewing its loan portfolio when calculating the general portion of the allowance for loan losses. The modification consisted of additional segmentation of the residential mortgage loan portfolio by items such as year of origination, loan-to-value ratios, owner or nonowner occupancy status and the purpose of

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the loan (purchase, cash-out refinance, no cash-out refinance or construction). As under our prior methodology, the allowance for loan loss for each segment of the loan portfolio is determined by calculating the historical loss of each segment for a two- to three-year look-back period and adding a qualitative adjustment for the following factors:

Changes in lending policies and procedures;

Changes in economic trends;

Changes in types of loans in the loan portfolio;

Changes in experience and ability of personnel in the loan origination and loan servicing departments;

Changes in the number and amount of delinquent loans and classified assets;

Changes in our internal loan review system;

Changes in the value of underlying collateral for collateral dependent loans;

Changes in any concentrations of credit; and

External factors such as competition, legal and regulatory requirements on the level of estimated credit losses in the existing loan portfolio.

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

Management considers the allowance for loan losses at September 30, 2012 to be at an appropriate level to provide for probable losses that can be estimated based on general and specific conditions. While the Company uses the best information it has available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. To the extent actual outcomes differ from the estimates, additional provisions for credit losses may be required that would reduce future earnings. In addition, as an integral part of their examination process, the Office of the Comptroller of the Currency will periodically review the allowance for loan losses. The Office of the Comptroller of the Currency may require the Company to increase the allowance based on their analysis of information available at the time of their examination.

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

| (Dollars in thousands)                | Residential<br>Mortgage | Construction,<br>Commercial<br>and Other<br>Mortgage<br>Loans | Home<br>Equity<br>Loans and<br>Lines of<br>Credit | Consumer<br>and Other | Unallocated   | Totals          |
|---------------------------------------|-------------------------|---|---|-----------------------|---------------|-----------------|
| <b>September 30, 2012:</b>            |                         |   |   |                       |               |                 |
| Allowance for loan losses:            |                         |   |   |                       |               |                 |
| Ending allowance balance:             |                         |   |   |                       |               |                 |
| Individually evaluated for impairment | \$ 0                    | \$ 0  | \$ 0  | \$ 0                  | \$ 0          | \$ 0            |
| Collectively evaluated for impairment | 590                     | 641   | 35  | 107                   | 122           | 1,495           |
| <b>Total ending allowance balance</b> | <b>\$ 590</b>           | <b>\$ 641</b>   | <b>\$ 35</b>                                      | <b>\$ 107</b>         | <b>\$ 122</b> | <b>\$ 1,495</b> |

|                                       |                   |                  |                  |                 |             |                   |
|---------------------------------------|-------------------|------------------|------------------|-----------------|-------------|-------------------|
| <b>Loans:</b>                         |                   |                  |                  |                 |             |                   |
| Ending loan balance:                  |                   |                  |                  |                 |             |                   |
| Individually evaluated for impairment | \$ 7,018          | \$ 0             | \$ 158           | \$ 0            | \$ 0        | \$ 7,176          |
| Collectively evaluated for impairment | 709,609           | 11,843           | 14,971           | 4,770           | 0           | 741,193           |
| <b>Total ending loan balance</b>      | <b>\$ 716,627</b> | <b>\$ 11,843</b> | <b>\$ 15,129</b> | <b>\$ 4,770</b> | <b>\$ 0</b> | <b>\$ 748,369</b> |

|                                       |               |               |               |               |              |                 |
|---------------------------------------|---------------|---------------|---------------|---------------|--------------|-----------------|
| <b>December 31, 2011:</b>             |               |               |               |               |              |                 |
| Allowance for loan losses:            |               |               |               |               |              |                 |
| Ending allowance balance:             |               |               |               |               |              |                 |
| Individually evaluated for impairment | \$ 0          | \$ 0          | \$ 0          | \$ 0          | \$ 0         | \$ 0            |
| Collectively evaluated for impairment | 631           | 285           | 258           | 291           | 76           | 1,541           |
| <b>Total ending allowance balance</b> | <b>\$ 631</b> | <b>\$ 285</b> | <b>\$ 258</b> | <b>\$ 291</b> | <b>\$ 76</b> | <b>\$ 1,541</b> |

|                                       |                   |                  |                  |                 |             |                   |
|---------------------------------------|-------------------|------------------|------------------|-----------------|-------------|-------------------|
| <b>Loans:</b>                         |                   |                  |                  |                 |             |                   |
| Ending loan balance:                  |                   |                  |                  |                 |             |                   |
| Individually evaluated for impairment | \$ 4,926          | \$ 184           | \$ 159           | \$ 3            | \$ 0        | \$ 5,272          |
| Collectively evaluated for impairment | 650,901           | 10,872           | 17,105           | 5,486           | 0           | 684,364           |
| <b>Total ending loan balance</b>      | <b>\$ 655,827</b> | <b>\$ 11,056</b> | <b>\$ 17,264</b> | <b>\$ 5,489</b> | <b>\$ 0</b> | <b>\$ 689,636</b> |

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

| (Dollars in thousands)                            | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Loans with no allocated allowance for loan losses | \$ 7,176              | \$ 5,272             |
| Loans with allocated allowance for loan losses    | 0                     | 0                    |
| <b>Total impaired loans</b>                       | <b>\$ 7,176</b>       | <b>\$ 5,272</b>      |
| <br>  |                       |                      |
| Amount of allocated loan loss allowance           | \$ 0                  | \$ 0                 |



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

| (Dollars in thousands)                       | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> |
|--|--------------------------------|---|
| <b>September 30, 2012:</b>                   |                                |   |
| With no related allowance recorded:          |                                |   |
| One- to four-family residential mortgages    | \$ 7,018                       | \$ 7,337                                |
| Home equity loans and lines of credit        | 158                            | 165                                     |
| <b>Total</b>                                 | <b>\$ 7,176</b>                | <b>\$ 7,502</b>                         |
| <br>   |                                |   |
| <b>December 31, 2011:</b>                    |                                |   |
| With no related allowance recorded:          |                                |   |
| One- to four-family residential mortgages    | \$ 4,926                       | \$ 5,206                                |
| Construction, commercial and other mortgages | 184                            | 241                                     |
| Home equity loans and lines of credit        | 159                            | 165                                     |
| Consumer and other                           | 3                              | 3                                       |
| <b>Total</b>                                 | <b>\$ 5,272</b>                | <b>\$ 5,615</b>                         |

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

| (Dollars in thousands)                    | <b>For the Three Months Ended<br/>September 30,</b> |   | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |   |
|---|---|---|--|---|
|   | <b>Average<br/>Recorded<br/>Investment</b>          | <b>Interest<br/>Income<br/>Recognized</b> | <b>Average<br/>Recorded<br/>Investment</b>             | <b>Interest<br/>Income<br/>Recognized</b> |
| <b>2012:</b>                              |   |   |  |   |
| With no related allowance recorded:       |   |   |  |   |
| One- to four-family residential mortgages | \$ 7,084  | \$ 69                                     | \$ 7,114   | \$ 153                                    |
| Home equity loans and lines of credit     | 159   | 2   | 158  | 5   |
| <b>Total</b>                              | <b>\$ 7,243</b>                                     | <b>\$ 71</b>                              | <b>\$ 7,272</b>  | <b>\$ 158</b>                             |
| <br>                                      |   |   |  |   |
| <b>2011:</b>                              |   |   |  |   |
| With no related allowance recorded:       |   |   |  |   |
| One- to four-family residential mortgages | \$ 4,292  | \$ 40                                     | \$ 4,982   | \$ 108                                    |
| Consumer and other                        | 29  | 0   | 54   | 0   |
| <b>Total</b>                              | <b>\$ 4,321</b>                                     | <b>\$ 40</b>                              | <b>\$ 5,036</b>  | <b>\$ 108</b>                             |

There were no loans individually evaluated for impairment with a related allowance for loan loss as of September 30, 2012 or December 31, 2011.

Impaired loans at September 30, 2012 and December 31, 2011 amounted to \$7.2 million and \$5.3 million, respectively, and included all nonaccrual and restructured loans. During the nine months ended September 30, 2012, the average recorded investment in impaired loans was \$7.3 million and interest





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income recognized on impaired loans was \$158,000. During the nine months ended September 30, 2011, the average recorded investment in impaired loans was \$5.0 million and interest income recognized on impaired loans was \$108,000.

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

|  | 30 - 59<br>Days Past<br>Due | 60 - 89<br>Days Past<br>Due | 90 Days or<br>Greater<br>Past Due | Total Past<br>Due | Loans Not<br>Past Due | Total<br>Loans | Nonaccrual<br>Loans | Loans<br>More<br>Than<br>90<br>Days Past<br>Due<br>and<br>Still<br>Accruing |
|--|-----------------------------|-----------------------------|-----------------------------------|-------------------|-----------------------|----------------|---------------------|---|
| (Dollars in thousands)                       |                             |                             |                                   |                   |                       |                |                     |   |
| September 30, 2012:                          |                             |                             |                                   |                   |                       |                |                     |   |
| One- to four-family residential mortgages    | \$ 1,401                    | \$ 0                        | \$ 1,855                          | \$ 3,256          | \$ 706,611            | \$ 709,867     | \$ 4,483            | \$ 0  |
| Multi-family residential mortgages           | 0                           | 0                           | 0                                 | 0                 | 6,760                 | 6,760          | 0                   | 0   |
| Construction, commercial and other mortgages | 0                           | 0                           | 0                                 | 0                 | 11,843                | 11,843         | 0                   | 0   |
| Home equity loans and lines of credit        | 0                           | 0                           | 0                                 | 0                 | 15,129                | 15,129         | 158                 | 0   |
| Loans on deposit accounts                    | 0                           | 0                           | 0                                 | 0                 | 482                   | 482            | 0                   | 0   |
| Consumer and other                           | 8                           | 1                           | 0                                 | 9                 | 4,279                 | 4,288          | 0                   | 0   |
| Total  | \$ 1,409                    | \$ 1                        | \$ 1,855                          | \$ 3,265          | \$ 745,104            | \$ 748,369     | \$ 4,641            | \$ 0  |
| December 31, 2011:                           |                             |                             |                                   |                   |                       |                |                     |   |
| One- to four-family residential mortgages    | \$ 499                      | \$ 0                        | \$ 2,148                          | \$ 2,647          | \$ 646,268            | \$ 648,915     | \$ 2,582            | \$ 0  |
| Multi-family residential mortgages           | 0                           | 0                           | 0                                 | 0                 | 6,912                 | 6,912          | 0                   | 0   |
| Construction, commercial and other mortgages | 0                           | 0                           | 184                               | 184               | 10,872                | 11,056         | 184                 | 0   |
| Home equity loans and lines of credit        | 168                         | 0                           | 0                                 | 168               | 17,096                | 17,264         | 159                 | 0   |
| Loans on deposit accounts                    | 0                           | 0                           | 0                                 | 0                 | 756                   | 756            | 0                   | 0   |
| Consumer and other                           | 11                          | 2                           | 3                                 | 16                | 4,717                 | 4,733          | 3                   | 0   |
| Total  | \$ 678                      | \$ 2                        | \$ 2,335                          | \$ 3,015          | \$ 686,621            | \$ 689,636     | \$ 2,928            | \$ 0  |

The Company primarily uses the aging of loans and accrual status to monitor the credit quality of its loan portfolio. When a mortgage loan becomes seriously delinquent (90 days or more contractually past due), it displays weaknesses which may result in a loss. As a loan becomes more delinquent, the likelihood of the borrower repaying the loan decreases and the loan becomes more collateral-dependent. A mortgage loan becomes collateral-dependent when the proceeds for repayment can be expected to 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 market value of the collateral less selling costs. Any commercial real estate, commercial, construction or equity loan that has a loan balance in excess of a specified amount is also periodically reviewed to determine whether the loan exhibits any weaknesses and is performing in accordance with its contractual terms.

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The Company had 19 nonaccrual loans with a book value of \$4.6 million at September 30, 2012 and 12 nonaccrual loans with a book value of \$2.9 million as of December 31, 2011. The Company collected or recognized interest income on nonaccrual loans of \$75,000 and \$8,000 during the nine months ended September 30, 2012 and 2011, respectively. The Company would have recognized additional interest income of \$119,000 and \$84,000 during the nine months ended September 30, 2012 and 2011, 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, 2012 and December 31, 2011.

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

|   | Number<br>of Loans | 2012   |   | Number<br>of Loans | 2011   |   |
|---|--------------------|--|---|--------------------|--|---|
|   |                    | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |                    | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |
| (Dollars in thousands)                  |                    |  |   |                    |  |   |
| <b>Three months ended September 30:</b> |                    |  |   |                    |  |   |
| One- to four-family residential         | 12                 | \$ 3,694                                       | \$ 3,694  | 0                  | \$ 0   | \$ 0  |
| <b>Total</b>                            | <b>12</b>          | <b>\$ 3,694</b>                                | <b>\$ 3,694</b>                                 | <b>0</b>           | <b>\$ 0</b>                                    | <b>\$ 0</b>                                     |
| <b>Nine months ended September 30:</b>  |                    |  |   |                    |  |   |
| One- to four-family residential         | 12                 | \$ 3,694                                       | \$ 3,694  | 0                  | \$ 0   | \$ 0  |
| <b>Total</b>                            | <b>12</b>          | <b>\$ 3,694</b>                                | <b>\$ 3,694</b>                                 | <b>0</b>           | <b>\$ 0</b>                                    | <b>\$ 0</b>                                     |

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

The Company had 22 troubled debt restructurings totaling \$6.1 million as of September 30, 2012 that were considered to be impaired. This total included 21 one- to four-family residential mortgage loans totaling \$6.0 million and one home equity loan for \$158,000. Eight of the loans, totaling \$2.5 million, are performing in accordance with their restructured terms and accruing interest at September 30, 2012. Twelve of the loans, totaling \$2.8 million, are performing in accordance with their restructured terms but not accruing interest at September 30, 2012. Two of the loans, for \$788,000, are 150 days or more delinquent and not accruing interest at September 30, 2012. There were 11 troubled debt restructurings totaling \$2.9 million as of December 31, 2011 that were considered to be impaired. This total included ten one- to four-family residential mortgage loans totaling \$2.8 million and one home equity loan for \$159,000. Eight of the loans, totaling \$2.3 million, are performing in accordance with their restructured terms and accruing interest at December 31, 2011. Two of the loans, totaling \$344,000, are performing in accordance with their restructured terms but not accruing interest at December 31, 2011. One of the loans, for \$248,000, is 59 days delinquent and not accruing interest at December 31, 2011. The increase in troubled debt restructurings primarily occurred when, in consultation with the Office of the Comptroller of the Currency, Territorial Savings Bank's primary regulator, we classified 12 loans that had been modified to provide interest-only payments, totaling \$3.7 million, as troubled debt restructurings. The increase in troubled debt restructuring has not had an effect on the adequacy of the Bank's loan loss allowance. Management considers the allowance for loan losses at September 30, 2012 to be at an appropriate level to provide for probable losses that can be estimated. 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.

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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 three months ended September 30, 2012 and 2011, the Company sold \$28.9 million and \$9.2 million, respectively, of mortgage loans held for sale and recognized gains of \$669,000 and \$138,000, respectively. During the nine months ended September 30, 2012 and 2011, the Company sold \$75.1 million and \$35.3 million, respectively, of mortgage loans held for sale and recognized gains of \$1.5 million and \$374,000, respectively. The Company had 14 loans held for sale totaling \$4.0 million at September 30, 2012 and 12 loans held for sale totaling \$3.2 million at December 31, 2011.

The Company serviced loans for others of \$92.4 million at September 30, 2012 and \$115.3 million at December 31, 2011. Of these amounts, \$5.1 million and \$6.2 million relate to securitizations for which the Company continues to hold the related mortgage-backed securities at September 30, 2012 and December 31, 2011, respectively. The amount of contractually specified servicing fees earned for the nine-month periods ended September 30, 2012 and 2011 was \$212,000 and \$266,000, respectively. The amount of contractually specified servicing fees earned for the three-month periods ended September 30, 2012 and 2011 was \$68,000 and \$87,000, respectively. The fees are reported in service fees on loan and deposit accounts in the consolidated statements of income.

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

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

| (Dollars in thousands)  | September 30, 2012   |                       | December 31, 2011    |                       |
|-------------------------|----------------------|-----------------------|----------------------|-----------------------|
|                         | Repurchase liability | Weighted average rate | Repurchase liability | Weighted average rate |
| <b>Maturing:</b>        |                      |                       |                      |                       |
| 1 year or less          | \$ 23,000            | 4.40%                 | \$ 28,300            | 4.75%                 |
| Over 1 year to 2 years  | 0                    | 0.00                  | 33,000               | 3.91                  |
| Over 2 years to 3 years | 47,000               | 2.11                  | 0                    | 0.00                  |
| Over 3 years to 4 years | 0                    | 0.00                  | 47,000               | 2.11                  |
|                         | \$ 70,000            | 2.86%                 | \$ 108,300           | 3.35%                 |

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

Below is a summary comparing the carrying value and fair value of securities pledged to secure repurchase agreements, the repurchase liability, and the amount at risk at September 30, 2012. 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 |
|------------------------|------------------------------|--------------------------|----------------------|----------------|-------------------------------------|
| <b>Maturing:</b>       |                              |                          |                      |                |                                     |
| Over 90 days           | \$ 80,059                    | \$ 85,924                | \$ 70,000            | \$ 15,924      | 23                                  |



**Table of Contents****(8) Employee Benefit Plans**

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

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

The components of net periodic benefit cost were as follows:

| (Dollars in thousands)                   | SERP  |   | SERP                                       |  |
|--|---|---|--|--|
|  | Three Months Ended<br>September 30,<br>2012 | Three Months Ended<br>September 30,<br>2011 | Nine Months Ended<br>September 30,<br>2012 | Nine Months Ended<br>September 30,<br>2011 |
| Net periodic benefit cost for the period |   |   |  |  |
| Service cost                             | \$ 49                                       | \$ 111                                      | \$ 147                                     | \$ 332                                     |
| Interest cost                            | 25  | 53  | 74   | 161  |
| Expected return on plan assets           | 0   | 0   | 0  | 0  |
| Amortization of prior service cost       | 0   | 0   | 0  | 0  |
| Recognized actuarial loss                | 0   | 0   | 0  | 0  |
| Recognized curtailment loss              | 0   | 0   | 0  | 0  |
| Net periodic benefit cost                | \$ 74                                       | \$ 164                                      | \$ 221                                     | \$ 493                                     |

**(9) Employee Stock Ownership Plan**

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

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

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Shares purchased by the ESOP are held by a trustee in an unallocated suspense account, and shares are released annually from the suspense account on a pro-rata basis as principal and interest payments are made by the ESOP to the Company. The trustee allocates the shares released among participants on the basis of each participant's proportional share of compensation relative to all participants. As shares are committed to be released from the suspense account, Territorial Savings Bank reports compensation expense based on the average fair value of shares released with a corresponding credit to stockholders' equity. The shares committed to be released are considered outstanding for earnings per share computations. Compensation expense recognized for the three months ended September 30, 2012 and 2011 amounted to \$271,000 and \$236,000, respectively. Compensation expense recognized for the nine months ended September 30, 2012 and 2011 amounted to \$759,000 and \$704,000, respectively.

Shares held by the ESOP trust were as follows:

|   | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|---|-------------------------------|------------------------------|
| Allocated shares                            | 179,439                       | 145,775                      |
| Unearned shares                             | 795,154                       | 831,853                      |
| <b>Total ESOP shares</b>                    | <b>974,593</b>                | <b>977,628</b>               |
| <br>  |                               |                              |
| Fair value of unearned shares, in thousands | \$ 18,249                     | \$ 16,429                    |

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, 2012 and 2011, we accrued \$80,000 and \$1,000, respectively, for the ESOP restoration plan. For the nine months ended September 30, 2012 and 2011, we accrued \$185,000 and \$159,000, respectively, for the ESOP restoration plan.

**(10) Share-Based Compensation**

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

Shares of our common stock issued under the Plan shall be authorized but unissued shares. The maximum number of shares that will be awarded under the plan will be 1,712,637 shares. Share-based compensation expense for the three months and nine months ended September 30, 2012 was \$693,000 and \$2.0 million, respectively.

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***Stock Options***

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

|   | Options | Weighted average exercise price | Remaining contractual life (years) | Aggregate intrinsic value (in thousands) |
|---|---------|---------------------------------|------------------------------------|--|
| Options outstanding at December 31, 2011  | 871,144 | \$ 17.36                        | 8.67                               | \$ 2,082                                 |
| Granted                                   | 3,085   | 23.62                           | 8.00                               | 0  |
| Exercised                                 | 41,275  | 17.36                           | 0.00                               | 0  |
| Forfeited                                 | 0       | 0.00                            | 0.00                               | 0  |
| Expired                                   | 0       | 0.00                            | 0.00                               | 0  |
| Options outstanding at September 30, 2012 | 832,954 | \$ 17.38                        | 7.92                               | \$ 4,640                                 |

As of September 30, 2012, the Company had \$2.8 million of unrecognized compensation costs related to stock options. The cost of stock options will be amortized over a five to six-year vesting period. There were 138,929 options vested in the nine months ending September 30, 2012.

The fair value of the Company's stock options was determined using the Black-Scholes option pricing formula. The following assumptions were used in the formula in 2010 and 2012:

|                                   | 2010     | 2012     |
|-----------------------------------|----------|----------|
| Expected volatility               | 31.98%   | 36.83%   |
| Risk-free interest rate           | 2.58%    | 0.81%    |
| Expected dividends                | 1.61%    | 1.86%    |
| Expected life (in years)          | 6.75     | 5.50     |
| Grant price for the stock options | \$ 17.36 | \$ 23.62 |

There were no options granted in 2011. There were 3,085 options granted in the nine months ended September 30, 2012.

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

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

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

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

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



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**Restricted Stock Awards**

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

The table below presents the restricted stock award activity for the nine months ended September 30, 2012:

|                                 | Restricted<br>stock awards | Weighted<br>average<br>grant date<br>fair value |
|---------------------------------|----------------------------|---|
| Nonvested at December 31, 2011  | 563,994                    | \$ 17.36  |
| Granted                         | 2,735                      | 23.62   |
| Vested                          | 113,332                    | 17.39   |
| Forfeited                       | 0                          | 0.00  |
| Nonvested at September 30, 2012 | 453,397                    | \$ 17.39  |

There were 2,735 restricted stock awards granted in the nine months ended September 30, 2012 at a price of \$23.62 per share.

As of September 30, 2012, the Company had \$7.7 million of unrecognized compensation cost related to restricted stock awards. The cost of the restricted stock awards will be amortized over a five to six-year vesting period.

**(11) Earnings Per Share**

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

| (Dollars in thousands, except share data)  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2012                                | 2011       | 2012                               | 2011       |
| Net income                                 | \$ 3,647                            | \$ 2,986   | \$ 11,033                          | \$ 9,371   |
| Weighted-average number of shares used in: |                                     |            |                                    |            |
| Basic earnings per share                   | 10,052,630                          | 10,659,532 | 10,126,371                         | 10,969,320 |
| Dilutive common stock equivalents:         |                                     |            |                                    |            |
| Stock options and restricted stock units   | 146,770                             | 176,117    | 79,037                             | 148,124    |
| Diluted earnings per share                 | 10,199,400                          | 10,835,649 | 10,205,408                         | 11,117,444 |
| Net income per common share, basic         | \$ 0.36                             | \$ 0.28    | \$ 1.09                            | \$ 0.85    |
| Net income per common share, diluted       | \$ 0.36                             | \$ 0.28    | \$ 1.08                            | \$ 0.84    |

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**(12) Other Comprehensive Loss**

The table below presents the changes in the components of other comprehensive loss:

| (Dollars in thousands)   | Three Months Ended September 30, |                              |                |                   |                              |                |
|--|----------------------------------|------------------------------|----------------|-------------------|------------------------------|----------------|
|  | Beginning Balance                | 2012<br>Comprehensive Income | Ending Balance | Beginning Balance | 2011<br>Comprehensive Income | Ending Balance |
| Unfunded pension liability                                     | \$ 2,966                         | \$ 0                         | \$ 2,966       | \$ 1,504          | \$ 0                         | \$ 1,504       |
| Noncredit related losses on securities not expected to be sold | 679                              | (177)                        | 502            | 679               | 0                            | 679            |
| Unrealized loss on securities                                  | 115                              | (8)                          | 107            | 135               | (2)                          | 133            |
|  | \$ 3,760                         | \$ (185)                     | \$ 3,575       | \$ 2,318          | \$ (2)                       | \$ 2,316       |

| (Dollars in thousands)   | Nine Months Ended September 30, |                              |                |                   |                              |                |
|--|---------------------------------|------------------------------|----------------|-------------------|------------------------------|----------------|
|  | Beginning Balance               | 2012<br>Comprehensive Income | Ending Balance | Beginning Balance | 2011<br>Comprehensive Income | Ending Balance |
| Unfunded pension liability                                     | \$ 2,966                        | \$ 0                         | \$ 2,966       | \$ 1,504          | \$ 0                         | \$ 1,504       |
| Noncredit related losses on securities not expected to be sold | 679                             | (177)                        | 502            | 679               | 0                            | 679            |
| Unrealized loss on securities                                  | 125                             | (18)                         | 107            | 322               | (189)                        | 133            |
|  | \$ 3,770                        | \$ (195)                     | \$ 3,575       | \$ 2,505          | \$ (189)                     | \$ 2,316       |

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

| (Dollars in thousands)   | Nine Months Ended September 30, |             |                  |               |             |                  |
|--|---------------------------------|-------------|------------------|---------------|-------------|------------------|
|  | Pretax Amount                   | 2012<br>Tax | After Tax Amount | Pretax Amount | 2011<br>Tax | After Tax Amount |
| Unfunded pension liability                                     | \$ 4,954                        | \$ (1,988)  | \$ 2,966         | \$ 2,488      | \$ (984)    | \$ 1,504         |
| Noncredit related losses on securities not expected to be sold | 812                             | (310)       | 502              | 1,106         | (427)       | 679              |
| Unrealized loss on securities                                  | 178                             | (71)        | 107              | 222           | (89)        | 133              |
|  | \$ 5,944                        | \$ (2,369)  | \$ 3,575         | \$ 3,816      | \$ (1,500)  | \$ 2,316         |

**(13) 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.



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Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

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

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

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

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

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

The trust preferred securities represent investments in a pool of debt obligations issued primarily by holding companies for Federal Deposit Insurance Corporation-insured financial institutions. The trust preferred securities market is considered to be inactive since there have been only six sales transactions of similar rated securities over the past 21 months and no new issues of pooled trust preferred securities have occurred since 2007. The fair value of our trust preferred securities was determined by an independent third-party pricing service that used a discounted cash flow model and included a review of all issuers within the pool. Our pricing service used a discount rate of three-month LIBOR plus 20.00% and provided a fair value estimate of \$9.20 per \$100 of par value for PreTSL XXIII. The fair value of the trust preferred securities are classified as Level 3 inputs because they are based on discounted cash flow models.

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

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

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

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**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<br>amount | Fair value | Fair Value Measurements Using |         |         |
|---|--------------------|------------|-------------------------------|---------|---------|
|   |                    |            | Level 1                       | Level 2 | Level 3 |
| <b>September 30, 2012</b>                             |                    |            |                               |         |         |
| <b>Assets</b>   |                    |            |                               |         |         |
| Cash and cash equivalents                             | \$ 155,265         | \$ 155,265 | \$ 155,265                    | \$ 0    | \$ 0    |
| Investment securities held to maturity                | 595,607            | 633,513    | 0                             | 633,187 | 326     |
| FHLB stock  | 12,238             | 12,238     | 12,238                        | 0       | 0       |
| Loans held for sale                                   | 4,032              | 4,282      | 0                             | 4,282   | 0       |
| Loans receivable, net                                 | 746,874            | 789,415    | 0                             | 0       | 789,415 |
| Accrued interest receivable                           | 4,676              | 4,676      | 4,676                         | 0       | 0       |
| Interest rate contracts                               | 662                | 662        | 0                             | 662     | 0       |
| <b>Liabilities</b>                                    |                    |            |                               |         |         |
| Deposits  | 1,226,527          | 1,228,263  | 1,017,448                     | 0       | 210,815 |
| Advances from the Federal Home Loan Bank              | 20,000             | 20,483     | 0                             | 0       | 20,483  |
| Securities sold under agreements to repurchase        | 70,000             | 72,768     | 0                             | 0       | 72,768  |
| Accounts payable and accrued expenses                 | 23,158             | 23,158     | 23,158                        | 0       | 0       |
| Interest rate contracts                               | 597                | 597        | 0                             | 597     | 0       |
| Current income taxes payable                          | 147                | 147        | 147                           | 0       | 0       |
| Advance payments by borrowers for taxes and insurance | 2,295              | 2,295      | 2,295                         | 0       | 0       |
| <b>December 31, 2011</b>                              |                    |            |                               |         |         |
| <b>Assets</b>   |                    |            |                               |         |         |
| Cash and cash equivalents                             | \$ 131,937         | \$ 131,937 | \$ 131,937                    | \$ 0    | \$ 0    |
| Investment securities held to maturity                | 653,871            | 687,319    | 0                             | 687,060 | 259     |
| FHLB stock  | 12,348             | 12,348     | 12,348                        | 0       | 0       |
| Loans held for sale                                   | 3,231              | 3,352      | 0                             | 3,352   | 0       |
| Loans receivable, net                                 | 688,095            | 790,220    | 0                             | 0       | 790,220 |
| Accrued interest receivable                           | 4,780              | 4,780      | 4,780                         | 0       | 0       |
| Interest rate contracts                               | 156                | 156        | 0                             | 156     | 0       |
| <b>Liabilities</b>                                    |                    |            |                               |         |         |
| Deposits  | 1,166,116          | 1,167,855  | 942,365                       | 0       | 225,490 |
| Advances from the Federal Home Loan Bank              | 20,000             | 20,525     | 0                             | 0       | 20,525  |
| Securities sold under agreements to repurchase        | 108,300            | 112,306    | 0                             | 0       | 112,306 |
| Accounts payable and accrued expenses                 | 22,816             | 22,816     | 22,816                        | 0       | 0       |
| Interest rate contracts                               | 139                | 139        | 0                             | 139     | 0       |
| Current income taxes payable                          | 3,114              | 3,114      | 3,114                         | 0       | 0       |
| Advance payments by borrowers for taxes and insurance | 3,264              | 3,264      | 3,264                         | 0       | 0       |

At September 30, 2012 and December 31, 2011, neither the commitment fees received on commitments to extend credit nor the fair value thereof was material to the consolidated financial statements of the Company.

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

| (Dollars in thousands)                | Level 1 | Level 2 | Level 3 | Total  |
|---------------------------------------|---------|---------|---------|--------|
| <b>September 30, 2012</b>             |         |         |         |        |
| Interest rate contracts - assets      | \$ 0    | \$ 662  | \$ 0    | \$ 662 |
| Interest rate contracts - liabilities | 0       | (597)   | 0       | (597)  |
| <b>December 31, 2011</b>              |         |         |         |        |
| Interest rate contracts - assets      | \$ 0    | \$ 156  | \$ 0    | \$ 156 |
| Interest rate contracts - liabilities | 0       | (139)   | 0       | (139)  |

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, 2012 and December 31, 2011 and the related losses for the nine months ended September 30, 2012 and the year ended December 31, 2011:

| (Dollars in thousands)     | Level 1 | Level 2 | Level 3  | Total    | Total Gains (Losses) |
|----------------------------|---------|---------|----------|----------|----------------------|
| <b>September 30, 2012</b>  |         |         |          |          |                      |
| Impaired loans             | \$ 0    | \$ 211  | \$ 5,335 | \$ 5,546 | \$ (163)             |
| Mortgage servicing assets  | 0       | 0       | 679      | 679      | (209)                |
| Trust preferred securities | 0       | 0       | 326      | 326      | 294                  |
| <b>December 31, 2011</b>   |         |         |          |          |                      |
| Impaired loans             | \$ 0    | \$ 885  | \$ 2,766 | \$ 3,651 | \$ (219)             |
| Mortgage servicing assets  | 0       | 0       | 970      | 970      | (34)                 |

The fair value of impaired loans that are considered to be collateral-dependent is determined using the value of collateral less estimated selling costs. The fair value of impaired loans that are not considered to be collateral-dependent is determined using a discounted cash flow analysis. Assumptions used in the analysis include the discount rate and projected cash flows. Gains and losses on impaired loans are included in the provision for loan losses in the consolidated statements of income. Mortgage servicing assets are valued using a cash flow model prepared by an independent third-party appraiser. Assumptions used in the model include mortgage prepayment speeds, discount rates, cost of servicing and ancillary income. Losses on mortgage servicing assets are included in service fees on loan and deposit accounts in the consolidated statements of income. The fair value of trust preferred securities was determined by an independent third-party pricing service using a discounted cash flow model. The assumptions used in the discounted cash flow model are discussed above. Gains and losses on trust preferred securities that are credit related are included in net other-than-temporary impairment losses in the consolidated statements of income. Gains and losses on trust preferred securities that are not credit related are included in other comprehensive income in the consolidated statements of comprehensive income.

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

| (Dollars in thousands)                    | Fair Value | Valuation Technique  | Unobservable Input     | Value                      |
|---|------------|----------------------|------------------------|----------------------------|
| <b>September 30, 2012:</b>                |            |                      |                        |                            |
| Impaired loans - non-collateral dependent | \$ 5,335   | Discounted cash flow | Discount rate (1)      | 3.73% - 6.94%              |
| Mortgage servicing assets                 | 679        | Discounted cash flow | Discount rate          | 10.00%                     |
|   |            |                      | Prepayment speed (PSA) | 191.5 - 332.1              |
|   |            |                      | Cost to service        |                            |
|   |            |                      | (Basis points)         | 40                         |
| Trust preferred securities                | 326        | Discounted cash flow | Discount rate          | Three-month LIBOR plus 20% |
| <b>December 31, 2011:</b>                 |            |                      |                        |                            |
| Impaired loans - non-collateral dependent | \$ 2,766   | Discounted cash flow | Discount rate (1)      | 3.73% - 6.94%              |
| Mortgage servicing assets                 | 970        | Discounted cash flow | Discount rate          | 10.00%                     |
|   |            |                      | Prepayment speed (PSA) | 180.1 - 437.9              |
|   |            |                      | Cost to service        |                            |
|   |            |                      | (Basis points)         | 40                         |

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

**(14) Subsequent Events**

On November 1, 2012, the Board of Directors of Territorial Bancorp Inc. declared a quarterly cash dividend of \$0.12 per share of common stock. The dividend is expected to be paid on November 29, 2012 to stockholders of record as of November 15, 2012.

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

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

statements of our goals, intentions and expectations;

statements regarding our business plans, prospects, growth and operating strategies;

statements regarding the asset quality of our loan and investment portfolios; and



estimates of our risks and future costs and benefits.

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

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

general economic conditions, either internationally, nationally or in our market areas, that are worse than expected;

competition among depository and other financial institutions;

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

adverse changes in the securities markets;

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

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

our ability to successfully integrate acquired entities, if any;

changes in consumer spending, borrowing and savings habits;

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

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**

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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, 2011.

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**Comparison of Financial Condition at September 30, 2012 and December 31, 2011**

**Assets.** At September 30, 2012, our assets were \$1.563 billion, an increase of \$25.1 million, or 1.6%, from \$1.538 billion at December 31, 2011. The growth in assets was primarily the result of an increase in loans receivable and cash and cash equivalents, which was partially offset by a decrease in investment securities.

**Cash and Cash Equivalents.** Cash and cash equivalents were \$155.3 million at September 30, 2012, an increase of \$23.3 million since December 31, 2011. The growth in cash and cash equivalents resulted primarily from a \$60.4 million increase in deposits, which was partially offset by cash used to pay off \$38.3 million of securities sold under agreements to repurchase.

**Loans.** Total loans, including \$4.0 million of loans held for sale, were \$750.9 million at September 30, 2012, or 48.1% of total assets. During the nine months ended September 30, 2012, the loan portfolio increased by \$59.6 million, or 8.6%. The increase in the loan portfolio occurred as the production of new one- to four-family residential loans exceeded principal repayments and loan sales. The continued high level of loan originations is due primarily to the current interest rate environment.

**Securities.** At September 30, 2012, our securities portfolio totaled \$595.6 million, or 38.1% of total assets. At September 30, 2012, all of such securities were classified as held-to-maturity and none of the underlying collateral consisted of subprime or Alt-A (traditionally defined as nonconforming loans having less than full documentation) loans. During the nine months ended September 30, 2012, our securities portfolio decreased by \$58.3 million, or 8.9%, as repayments and sales exceeded purchases.

At September 30, 2012, we owned trust preferred securities with a carrying value of \$326,000. 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 six transactions have occurred over the past 21 months in similar tranches to the 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. The Company used a discount rate equal to three-month LIBOR plus 20.00% and determined fair value to be \$9.20 per \$100 of par value.

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, 2012, as the present value of cash flows exceeded the amortized cost basis of \$1.1 million.

At September 30, 2012, these trust preferred securities are rated C by Fitch.

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

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**Deposits.** Deposits were \$1.227 billion at September 30, 2012, an increase of \$60.4 million, or 5.2%, since December 31, 2011. The increase in deposits was caused by our continuing to promote higher-than-market rates for our savings accounts.

**Borrowings.** Our borrowings consist primarily 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, 2012, our borrowings decreased by \$38.3 million, or 29.9%, to \$90.0 million, due to the pay off of securities sold under agreements to repurchase. We have not required any other borrowings to fund our operations. Instead, we have primarily funded our operations with the net proceeds from our stock offering, additional deposits, proceeds from loan sales and principal repayments on loans and mortgage-backed securities.

**Average Balances and Yields**

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

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|  | For the Three Months Ended September 30, |           |  |                                   |           |                    |
|--|--|-----------|--|-----------------------------------|-----------|--------------------|
|  | 2012                                     |           |  | 2011                              |           |                    |
|  | Average<br>Outstanding<br>Balance        | Interest  | Yield/<br>Rate (1)<br>(Dollars in thousands) | Average<br>Outstanding<br>Balance | Interest  | Yield/<br>Rate (1) |
| <b>Interest-earning assets:</b>                          |  |           |  |                                   |           |                    |
| Loans:   |  |           |  |                                   |           |                    |
| Real estate loans:                                       |  |           |  |                                   |           |                    |
| First mortgage:  |  |           |  |                                   |           |                    |
| One- to four-family residential (2)                      | \$ 703,000                               | \$ 8,629  | 4.91%  | \$ 618,576                        | \$ 8,127  | 5.26%              |
| Multi-family residential                                 | 6,826                                    | 104       | 6.09   | 6,082                             | 97        | 6.38               |
| Construction, commercial and other                       | 11,652                                   | 158       | 5.42   | 14,512                            | 217       | 5.98               |
| Home equity loans and lines of credit                    | 15,207                                   | 222       | 5.84   | 18,052                            | 272       | 6.03               |
| Other loans  | 4,791                                    | 74        | 6.18   | 5,244                             | 85        | 6.48               |
| Total loans  | 741,476                                  | 9,187     | 4.96   | 662,466                           | 8,798     | 5.31               |
| Investment securities:                                   |  |           |  |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities (2) | 612,325                                  | 5,551     | 3.63   | 648,645                           | 6,907     | 4.26               |
| Trust preferred securities                               | 35                                       | 0         | 0.00   | 32                                | 0         | 0.00               |
| Total securities   | 612,360                                  | 5,551     | 3.63   | 648,677                           | 6,907     | 4.26               |
| Other  | 160,494                                  | 88        | 0.22   | 154,679                           | 85        | 0.22               |
| Total interest-earning assets                            | 1,514,330                                | 14,826    | 3.92   | 1,465,822                         | 15,790    | 4.31               |
| Non-interest-earning assets                              | 48,105                                   |           |  | 51,035                            |           |                    |
| Total assets   | \$ 1,562,435                             |           |  | \$ 1,516,857                      |           |                    |
| <b>Interest-bearing liabilities:</b>                     |  |           |  |                                   |           |                    |
| Savings accounts   | \$ 861,845                               | \$ 1,108  | 0.51%  | \$ 776,218                        | \$ 1,178  | 0.61%              |
| Certificates of deposit                                  | 212,099                                  | 375       | 0.71   | 222,619                           | 510       | 0.92               |
| Money market accounts                                    | 532                                      | 0         | 0.00   | 510                               | 1         | 0.78               |
| Checking and Super NOW accounts                          | 115,715                                  | 9         | 0.03   | 106,229                           | 11        | 0.04               |
| Total interest-bearing deposits                          | 1,190,191                                | 1,492     | 0.50   | 1,105,576                         | 1,700     | 0.62               |
| Federal Home Loan Bank advances                          | 19,998                                   | 105       | 2.10   | 20,001                            | 105       | 2.10               |
| Securities sold under agreements to repurchase           | 82,099                                   | 629       | 3.06   | 119,927                           | 1,067     | 3.56               |
| Total interest-bearing liabilities                       | 1,292,288                                | 2,226     | 0.69   | 1,245,504                         | 2,872     | 0.92               |
| Non-interest-bearing liabilities                         | 51,540                                   |           |  | 48,860                            |           |                    |
| Total liabilities  | 1,343,828                                |           |  | 1,294,364                         |           |                    |
| Stockholders' equity                                     | 218,607                                  |           |  | 222,494                           |           |                    |
| Total liabilities and stockholders' equity               | \$ 1,562,435                             |           |  | \$ 1,516,858                      |           |                    |
| Net interest income                                      |  | \$ 12,600 |  |                                   | \$ 12,918 |                    |
| Net interest rate spread (3)                             |  |           | 3.23%  |                                   |           | 3.39%              |
| Net interest-earning assets (4)                          | \$ 222,042                               |           |  | \$ 220,318                        |           |                    |
| Net interest margin (5)                                  |  |           | 3.33%  |                                   |           | 3.53%              |
| Interest-earning assets to interest-bearing liabilities  | 117.18%                                  |           |  | 117.69%                           |           |                    |

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- (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, |           |  |                                   |           |                    |
|--|---|-----------|--|-----------------------------------|-----------|--------------------|
|  | 2012                                    |           |  | 2011                              |           |                    |
|  | Average<br>Outstanding<br>Balance       | Interest  | Yield/<br>Rate (1)<br>(Dollars in thousands) | Average<br>Outstanding<br>Balance | Interest  | Yield/<br>Rate (1) |
| <b>Interest-earning assets:</b>                          |   |           |  |                                   |           |                    |
| Loans:   |   |           |  |                                   |           |                    |
| Real estate loans:                                       |   |           |  |                                   |           |                    |
| First mortgage:  |   |           |  |                                   |           |                    |
| One- to four-family residential (2)                      | \$ 682,826                              | \$ 25,575 | 4.99%  | \$ 614,515                        | \$ 24,400 | 5.29%              |
| Multi-family residential                                 | 6,755                                   | 311       | 6.14   | 6,090                             | 293       | 6.41               |
| Construction, commercial and other                       | 11,870                                  | 500       | 5.62   | 14,246                            | 644       | 6.03               |
| Home equity loans and lines of credit                    | 16,062                                  | 707       | 5.87   | 18,636                            | 850       | 6.08               |
| Other loans  | 5,056                                   | 233       | 6.14   | 5,374                             | 257       | 6.38               |
| Total loans  | 722,569                                 | 27,326    | 5.04   | 658,861                           | 26,444    | 5.35               |
| Investment securities:                                   |   |           |  |                                   |           |                    |
| U.S. government sponsored mortgage-backed securities (2) | 632,208                                 | 18,360    | 3.87   | 627,718                           | 20,167    | 4.28               |
| Trust preferred securities                               | 33                                      | 0         | 0.00   | 32                                | 0         | 0.00               |
| Total securities   | 632,241                                 | 18,360    | 3.87   | 627,750                           | 20,167    | 4.28               |
| Other  | 158,197                                 | 259       | 0.22   | 157,126                           | 258       | 0.22               |
| Total interest-earning assets                            | 1,513,007                               | 45,945    | 4.05   | 1,443,737                         | 46,869    | 4.33               |
| Non-interest-earning assets                              | 51,758                                  |           |  | 50,322                            |           |                    |
| Total assets   | \$ 1,564,765                            |           |  | \$ 1,494,059                      |           |                    |
| <b>Interest-bearing liabilities:</b>                     |   |           |  |                                   |           |                    |
| Savings accounts   | \$ 842,717                              | \$ 3,354  | 0.53%  | \$ 763,819                        | \$ 3,540  | 0.62%              |
| Certificates of deposit                                  | 217,268                                 | 1,262     | 0.77   | 214,755                           | 1,528     | 0.95               |
| Money market accounts                                    | 520                                     | 1         | 0.26   | 587                               | 2         | 0.45               |
| Checking and Super NOW accounts                          | 113,634                                 | 27        | 0.03   | 106,711                           | 39        | 0.05               |
| Total interest-bearing deposits                          | 1,174,139                               | 4,644     | 0.53   | 1,085,872                         | 5,109     | 0.63               |
| Federal Home Loan Bank advances                          | 20,000                                  | 313       | 2.09   | 18,901                            | 295       | 2.08               |
| Securities sold under agreements to repurchase           | 96,550                                  | 2,364     | 3.26   | 115,075                           | 3,153     | 3.65               |
| Total interest-bearing liabilities                       | 1,290,689                               | 7,321     | 0.76   | 1,219,848                         | 8,557     | 0.94               |
| Non-interest-bearing liabilities                         | 56,029                                  |           |  | 47,837                            |           |                    |
| Total liabilities  | 1,346,718                               |           |  | 1,267,685                         |           |                    |
| Stockholders' equity                                     | 218,047                                 |           |  | 226,374                           |           |                    |
| Total liabilities and stockholders' equity               | \$ 1,564,765                            |           |  | \$ 1,494,059                      |           |                    |
| Net interest income                                      |   | \$ 38,624 |  |                                   | \$ 38,312 |                    |
| Net interest rate spread (3)                             |   |           | 3.29%  |                                   |           | 3.39%              |
| Net interest-earning assets (4)                          | \$ 222,318                              |           |  | \$ 223,889                        |           |                    |
| Net interest margin (5)                                  |   |           | 3.40%  |                                   |           | 3.54%              |
| Interest-earning assets to interest-bearing liabilities  | 117.22%                                 |           |  | 118.35%                           |           |                    |



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- (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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**Table of Contents****Comparison of Operating Results for the Three Months Ended September 30, 2012 and 2011**

**General.** Net income increased by \$661,000, or 22.1%, to \$3.6 million for the three months ended September 30, 2012 from \$3.0 million for the three months ended September 30, 2011. The increase in net income was caused by a \$646,000 decrease in interest expense, a \$754,000 increase in noninterest income and a \$624,000 decrease in noninterest expense. This was partially offset by a \$964,000 decrease in interest and dividend income, a \$206,000 increase in provision for loan losses and a \$193,000 increase in income taxes.

**Net Interest Income.** Net interest income decreased by \$318,000, or 2.5%, to \$12.6 million for the three months ended September 30, 2012 compared to \$12.9 million for the three months ended September 30, 2011. Interest and dividend income decreased by \$964,000, or 6.1%, due primarily to a 39 basis point decrease in the average yield on interest-earning assets that was partially offset by a \$48.5 million increase in the average balance. Interest expense decreased by \$646,000, or 22.5%, due to a 23 basis point decrease in the average cost of interest-bearing liabilities that was partially offset by a \$46.8 million increase in the average balance of interest-bearing liabilities. The interest rate spread and net interest margin were 3.23% and 3.33%, respectively, for the three months ended September 30, 2012, compared to 3.39% and 3.53%, respectively, for the three months ended September 30, 2011.

**Interest and Dividend Income.** Interest and dividend income decreased by \$964,000, or 6.1%, to \$14.8 million for the three months ended September 30, 2012 from \$15.8 million for the three months ended September 30, 2011. Interest income on investment securities decreased by \$1.4 million, or 19.6%, to \$5.6 million for the three months ended September 30, 2012 from \$6.9 million for the three months ended September 30, 2011. The decrease in interest income on securities occurred primarily because of a \$36.3 million decrease in the average securities balance and a 63 basis point decrease in the average securities yield. The decline in the average yield on investments occurred as repayments on higher yielding mortgage-backed securities were reinvested at lower yields. Interest income on loans increased by \$389,000, or 4.4%, to \$9.2 million for the three months ended September 30, 2012 from \$8.8 million for the three months ended September 30, 2011. The increase in interest income on loans occurred because the average balance of loans grew by \$79.0 million, or 11.9%, as new loan originations exceeded loan repayments and loan sales. This increase in interest income was partially offset by a 35 basis point decline in the average loan yield to 4.96% for the three months ended September 30, 2012 compared to 5.31% for the three months ended September 30, 2011. The decline in the average yield on loans occurred because of an increase in repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio.

**Interest Expense.** Interest expense decreased by \$646,000, or 22.5%, to \$2.2 million for the three months ended September 30, 2012 compared to \$2.9 million for the three months ended September 30, 2011. Interest expense on securities sold under agreements to repurchase decreased by \$438,000, or 41.0%, during the three months ended September 30, 2012. This decrease was caused by a \$37.8 million, or 31.5%, decrease in the average outstanding balance and a 50 basis point decrease in the average interest rate to 3.06% for the three months ended September 30, 2012 compared to 3.56% for the three months ended September 30, 2011. The decrease in the average outstanding balance was primarily due to the maturity of \$10.3 million and the prepayment of \$10.0 million of borrowings during the three months ended September 30, 2012. Interest expense on deposits decreased by \$208,000, or 12.2%, to \$1.5 million for the three months ended September 30, 2012 from \$1.7 million for the three months ended September 30, 2011. During the three months ended September 30, 2012, interest expense on certificates of deposit and savings accounts declined by \$135,000 and \$70,000, respectively, due to a decrease in the average interest rates of 21 and 10 basis points, respectively. We lowered the rates we

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pay on certificates of deposit and savings accounts due to declining market interest rates and increased liquidity from principal repayments on loans and mortgage-backed securities. However, the interest rates on our savings accounts are still higher than market interest rates. The decrease in the average interest rate on deposits was partially offset by an \$84.6 million, or 7.7%, increase in the average balance of deposit accounts.

**Provision for Loan Losses.** We recorded a provision for loan losses of \$167,000 for the three months ended September 30, 2012 and a \$39,000 reversal of loan loss provisions for the three months ended September 30, 2011. The provision for loan losses for the three months ended September 30, 2012 included \$119,000 of losses on troubled debt restructurings and a \$38,000 increase to the general loss allowance and resulted in a ratio of allowance for loan losses to total loans of 0.20% at September 30, 2012. The reversal of loan loss provisions for the three months ended September 30, 2011 was primarily due to a \$1.2 million decrease in the construction, commercial and other loan portfolio and resulted in a ratio of the allowance for loan losses to total loans of 0.23% at September 30, 2011. Nonaccrual loans totaled \$4.6 million at September 30, 2012, or 0.62% of total loans at that date, compared to \$2.4 million of nonaccrual loans at September 30, 2011, or 0.36% of total loans at that date. Nonaccrual loans as of September 30, 2012 and 2011 consisted primarily of one- to four-family residential real estate loans. The increase in nonaccrual loans primarily occurred when, in consultation with the Office of the Comptroller of the Currency, Territorial Savings Bank's primary regulator, we classified 11 loans that had been modified to provide interest-only payments, totaling \$2.7 million, as nonaccrual. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2012 and 2011. 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, 2012 and 2011.

|   | Three Months Ended |                    | Change    |          |
|---|--------------------|--------------------|-----------|----------|
|   | September 30, 2012 | September 30, 2011 | \$ Change | % Change |
|   | (In thousands)     |                    |           |          |
| Service fees on loan and deposit accounts | \$ 444             | \$ 534             | \$ (90)   | (16.9)%  |
| Income on bank-owned life insurance       | 239                | 245                | (6)       | (2.4)%   |
| Gain on sale of investment securities     | 429                | 74                 | 355       | 479.7%   |
| Gain on sale of loans                     | 669                | 138                | 531       | 384.8%   |
| Other                                     | 141                | 177                | (36)      | (20.3)%  |
| Total                                     | \$ 1,922           | \$ 1,168           | \$ 754    | 64.6%    |

Noninterest income rose by \$754,000 for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. During the three months ended September 30, 2012 and 2011, we sold \$28.9 million and \$9.2 million, respectively, of mortgage loans held for sale and recognized gains of \$669,000 and \$138,000, respectively. During the three months ended September 30, 2012, we also sold \$5.0 million of held-to-maturity investment securities and recognized a gain of \$429,000. The sale of these securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio. During the three months ended September 30, 2011, we sold \$16.4 million of investment securities and recognized a gain of \$74,000.

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**Noninterest Expense.** The following table summarizes changes in noninterest expense between the three months ended September 30, 2012 and 2011.

|   | Three Months Ended    |                       | Change          |               |
|---|-----------------------|-----------------------|-----------------|---------------|
|   | September 30,<br>2012 | September 30,<br>2011 | \$ Change       | % Change      |
|   | (In thousands)        |                       |                 |               |
| Salaries and employee benefits            | \$ 5,202              | \$ 6,017              | \$ (815)        | (13.5)%       |
| Occupancy                                 | 1,316                 | 1,267                 | 49              | 3.9%          |
| Equipment                                 | 800                   | 792                   | 8               | 1.0%          |
| Federal deposit insurance premiums        | 192                   | 191                   | 1               | 0.5%          |
| Loss on extinguishment of debt            | 123                   | 0                     | 123             | n/a           |
| Other general and administrative expenses | 964                   | 954                   | 10              | 1.0%          |
| <b>Total</b>                              | <b>\$ 8,597</b>       | <b>\$ 9,221</b>       | <b>\$ (624)</b> | <b>(6.8)%</b> |

Noninterest expense declined by \$624,000 for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. Salaries and employee benefits decreased by \$815,000 during the three months ended September 30, 2012 primarily because the Company recognized \$696,000 of stock benefit plan expenses when a director passed away during the three months ended September 30, 2011. In addition, the Company recognized a \$326,000 increase in the credit to compensation expense for the cost of originating new mortgage loans because of an increase in new loan originations. The Receivables topic of the FASB ASC allows financial institutions to take a credit against compensation expense for the direct cost of originating loans. During the three months ended September 30, 2012, the Company prepaid \$10.0 million of securities sold under agreements to repurchase, which had a weighted-average interest rate of 2.78%, and incurred \$123,000 of prepayment penalties, which is reported as loss on extinguishment of debt. The prepayment of this borrowing will reduce interest expense in future periods on securities sold under agreements to repurchase.

**Income Tax Expense.** Income taxes were \$2.1 million for the three months ended September 30, 2012, reflecting an effective tax rate of 36.7% compared to \$1.9 million for the three months ended September 30, 2011, reflecting an effective tax rate of 39.1%. The decrease in the effective tax rate for the three months ended September 30, 2012 can be primarily attributed to an increase in permanent tax benefits related to our share-based compensation plans.

**Comparison of Operating Results for the Nine Months Ended September 30, 2012 and 2011**

**General.** Net income increased by \$1.7 million, or 17.7%, to \$11.0 million for the nine months ended September 30, 2012 from \$9.4 million for the nine months ended September 30, 2011. The increase in net income was caused by a \$1.3 million increase in noninterest income, a \$1.2 million decrease in interest expense, and a \$542,000 decrease in non-interest expense. This was partially offset by a \$924,000 decrease in interest and dividend income, a \$357,000 increase in income taxes and an \$89,000 increase in provision for loan losses.

**Net Interest Income.** Net interest income increased by \$312,000, or 0.8%, to \$38.6 million for the nine months ended September 30, 2012 compared to \$38.3 million for the nine months ended September 30, 2011. Interest and dividend income decreased by \$924,000, or 2.0%, due primarily to a 28 basis point decrease in the average yield on interest-earning assets that was partially offset by a \$69.3 million increase in the average balance. Interest expense decreased by \$1.2 million, or 14.4%, due to an 18 basis point decrease in the average cost of interest-bearing liabilities that was partially offset by a \$70.8 million increase in the average balance. The interest rate spread and net interest margin were 3.29% and 3.40%, respectively, for the nine months ended September 30, 2012, compared to 3.39% and 3.54%, respectively, for the nine months ended September 30, 2011.

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**Interest and Dividend Income.** Interest and dividend income decreased by \$924,000, or 2.0%, to \$45.9 million for the nine months ended September 30, 2012 from \$46.9 million for the nine months ended September 30, 2011. Interest income on investment securities decreased by \$1.8 million, or 9.0%, to \$18.4 million for the nine months ended September 30, 2012 from \$20.2 million for the nine months ended September 30, 2011. The decrease in interest income on securities occurred primarily because of a 41 basis point decrease in the average securities yield that was partially offset by a \$4.5 million increase in the average securities balance. The decline in the average yield on investments occurred because of an increase in repayments on higher yielding mortgage-backed securities that were reinvested at lower yields. Interest income on loans increased by \$882,000, or 3.3%, to \$27.3 million for the nine months ended September 30, 2012 from \$26.4 million for the nine months ended September 30, 2011. The increase in interest income on loans occurred because the average balance of loans grew by \$63.7 million, or 9.7%, as new loan originations exceeded loan repayments and loan sales. This increase in interest income was partially offset by a 31 basis point decline in the average loan yield to 5.04% for the nine months ended September 30, 2012 compared to 5.35% for the nine months ended September 30, 2011. The decline in the average yield on loans occurred because of an increase in repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio.

**Interest Expense.** Interest expense decreased by \$1.2 million, or 14.4%, to \$7.3 million for the nine months ended September 30, 2012 compared to \$8.6 million for the nine months ended September 30, 2011. Interest expense on securities sold under agreements to repurchase decreased by \$789,000, or 25.0%, to \$2.4 million for the nine months ended September 30, 2012 compared to \$3.2 million for the nine months ended September 30, 2011. The decrease in interest expense on securities sold under agreements to repurchase was caused by an \$18.5 million, or 16.1%, decrease in the average outstanding balance and a 39 basis point decrease in the average interest rate. The decrease in the average outstanding balance of securities sold under agreements to repurchase occurred because of the repayment of \$25.2 million of maturing borrowings and prepayment of \$25.0 million of borrowings during the past 12 months. Interest expense on deposits decreased by \$465,000, or 9.1%, to \$4.6 million for the nine months ended September 30, 2012 from \$5.1 million for the nine months ended September 30, 2011. During the nine months ended September 30, 2012, interest expense on certificates of deposit and savings accounts declined by \$266,000 and \$186,000, respectively, primarily due to decreases of 18 and nine basis points, respectively, in the average interest rates. We lowered the rates we pay on certificates of deposit and savings accounts due to declining market interest rates and increased liquidity from principal repayments on loans and mortgage-backed securities. However, the interest rates on our savings accounts are still higher than market interest rates. The decrease in the average interest rate on deposits was partially offset by an \$88.3 million, or 8.1%, increase in the average balance of deposit accounts.

**Provision for Loan Losses.** For the nine months ended September 30, 2012 and 2011, we recorded provisions for loan losses of \$172,000 and \$83,000, respectively, and the provisions for loan losses reflected net charge-offs of \$218,000 and \$19,000, respectively. At September 30, 2012 and 2011, the provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.20% and 0.23%, respectively. Nonaccrual loans totaled \$4.6 million at September 30, 2012, or 0.62% of total loans at that date, compared to \$2.4 million of nonaccrual loans at September 30, 2011, or 0.36% of total loans at that date. Nonaccrual loans as of September 30, 2012 and 2011 consisted primarily of one- to four-family residential real estate loans. The increase in nonaccrual loans primarily occurred when, in consultation with the Office of the Comptroller of the Currency, Territorial Savings Bank's primary regulator, we classified 11 loans that had been modified to

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provide interest-only payments, totaling \$2.7 million, as nonaccrual. To the best of our knowledge, we have provided for all losses that are both probable and reasonable to estimate at September 30, 2012 and 2011. For additional information see footnote (6) Loans Receivable and Allowance for Loan Losses in our Notes to Consolidated Financial Statements.

**Noninterest Income.** The following table summarizes changes in noninterest income between the nine months ended September 30, 2012 and 2011.

|   | Nine Months Ended<br>September 30, |          | Change    |          |
|---|------------------------------------|----------|-----------|----------|
|   | 2012                               | 2011     | \$ Change | % Change |
|   | (In thousands)                     |          |           |          |
| Service fees on loan and deposit accounts | \$ 1,474                           | \$ 1,690 | \$ (216)  | (12.8)%  |
| Income on bank-owned life insurance       | 706                                | 725      | (19)      | (2.6)%   |
| Gain on sale of investment securities     | 729                                | 140      | 589       | 420.7%   |
| Gain on sale of loans                     | 1,516                              | 374      | 1,142     | 305.3%   |
| Other                                     | 346                                | 588      | (242)     | (41.2)%  |
| Total                                     | \$ 4,771                           | \$ 3,517 | \$ 1,254  | 35.7%    |

Noninterest income rose by \$1.3 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. During the nine months ended September 30, 2012 and 2011, we sold \$75.1 million and \$35.3 million, respectively, of mortgage loans held for sale and recognized gains of \$1.5 million and \$374,000, respectively. During the nine months ended September 30, 2012, we also sold \$9.3 million of held-to-maturity investment securities and recognized a gain of \$729,000. The sale of these securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio. During the nine months ended September 30, 2011, we sold \$36.2 million of available-for-sale investment securities and recognized a gain of \$140,000.

**Noninterest Expense.** The following table summarizes changes in noninterest expense between the nine months ended September 30, 2012 and 2011.

|   | Nine Months Ended<br>September 30, |           | Change     |          |
|---|------------------------------------|-----------|------------|----------|
|   | 2012                               | 2011      | \$ Change  | % Change |
|   | (In thousands)                     |           |            |          |
| Salaries and employee benefits            | \$ 15,416                          | \$ 16,630 | \$ (1,214) | (7.3)%   |
| Occupancy                                 | 3,930                              | 3,714     | 216        | 5.8%     |
| Equipment                                 | 2,423                              | 2,366     | 57         | 2.4%     |
| Federal deposit insurance premiums        | 574                                | 678       | (104)      | (15.3)%  |
| Loss on extinguishment of debt            | 321                                | 0         | 321        | n/a      |
| Other general and administrative expenses | 3,069                              | 2,887     | 182        | 6.3%     |
| Total                                     | \$ 25,733                          | \$ 26,275 | \$ (542)   | (2.1)%   |

Noninterest expense decreased by \$542,000 for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. Salaries and employee benefits decreased by \$1.2 million during the nine months ended September 30, 2012 primarily because during the nine months ended September 30, 2011, the Company recognized \$696,000 of stock benefit plan expenses when a director passed away. In addition, the Company recognized a \$700,000 increase in the credit to compensation expense for the cost of originating new mortgage loans because of an increase in new loan originations. The Receivables topic of the FASB ASC allows financial institutions to take a credit



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against compensation expense for the direct cost of originating loans. During the nine months ended September 30, 2012, the Company prepaid \$25.0 million of securities sold under agreements to repurchase, which had a weighted-average interest rate of 4.07%, and incurred \$321,000 of prepayment penalties, which is reported as loss on extinguishment of debt. The prepayment of this borrowing will reduce interest expense in future periods on securities sold under agreements to repurchase. Occupancy expense increased by \$216,000 during the nine months ended September 30, 2012 due to higher repair and maintenance costs, rent, utilities and depreciation expenses. Other general and administrative expenses increased by \$182,000 during the nine months ended September 30, 2012 due to higher professional fees, audit fees, and real estate owned expense.

**Income Tax Expense.** Income taxes were \$6.5 million for the nine months ended September 30, 2012, reflecting an effective tax rate of 36.9% compared to \$6.1 million for the nine months ended September 30, 2011, reflecting an effective tax rate of 39.4%. The decrease in the effective tax rate for the nine months ended September 30, 2012 can be primarily attributed to an increase in permanent tax benefits related to our share-based compensation plans.

## **Liquidity and Capital Resources**

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, cash balances at the Federal Reserve Bank, loan repayments, advances from the Federal Home Loan Bank of Seattle, securities sold under agreements to repurchase, proceeds from loan and security sales and maturities and principal repayments on held-to-maturity and available-for-sale securities. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We have established an Asset/Liability Management Committee, consisting of our 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, 2012.

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

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

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

Our most liquid asset is cash and cash equivalents. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2012, cash and cash equivalents totaled \$155.3 million. On that date, we had \$70.0 million in securities sold under agreements to repurchase outstanding and \$20.0 million of Federal Home Loan Bank advances outstanding, with the ability to borrow an additional \$371.5 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.

At September 30, 2012, we had \$51.6 million in loan commitments outstanding, most of which were for fixed-rate loans. In addition to commitments to originate loans, we had \$21.5 million in unused lines of credit to borrowers as of September 30, 2012. Certificates of deposit due within one year at September 30, 2012 totaled \$166.5 million, or 13.6% 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, 2013. 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 three months ended September 30, 2012 and 2011, we originated \$96.3 million and \$41.1 million of loans, respectively, and purchased \$45.2 million and \$45.4 million of securities, respectively. During the nine months ended September 30, 2012 and 2011, we originated \$263.8 million and \$146.3 million of loans, respectively, and purchased \$112.6 million and \$211.3 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. Total deposits were \$1.227 billion and \$1.166 billion at September 30, 2012 and December 31, 2011, respectively. We experienced net increases in deposits of \$60.4 million and \$62.8 million for the nine months ended September 30, 2012 and 2011, 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 totaled \$20.0 million at September 30, 2012 and 2011. We have the ability to borrow up to an additional \$371.5 million and \$352.6 million from the Federal Home Loan Bank of Seattle as of September 30, 2012 and 2011, respectively. We also utilize securities sold under agreements to repurchase as another borrowing source. Securities sold under agreements to repurchase totaled \$70.0 million and \$120.2 million at September 30, 2012 and 2011, respectively. Securities sold under agreements to repurchase decreased by \$38.3 million for the nine months ended September 30, 2012, compared to an increase of \$15.0 million for the nine months ended September 30, 2011.

Territorial Savings Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At September 30, 2012, 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, 2012 and December 31, 2011.

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As of September 30, 2012

(Dollars in thousands)

|                           | Required | Territorial Savings Bank |        |
|---------------------------|----------|--------------------------|--------|
| Tier 1 Capital            | 4%       | \$ 210,874               | 13.47% |
| Total Risk-Based Capital  | 8%       | \$ 212,393               | 37.99% |
| Tier 1 Risk-Based Capital | 4%       | \$ 210,874               | 37.72% |

As of December 31, 2011

(Dollars in thousands)

|                           | Required | Territorial Savings Bank |        |
|---------------------------|----------|--------------------------|--------|
| Tier 1 Capital            | 4%       | \$ 201,060               | 13.07% |
| Total Risk-Based Capital  | 8%       | \$ 202,601               | 38.76% |
| Tier 1 Risk-Based Capital | 4%       | \$ 201,060               | 38.47% |

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

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

**Contractual Obligations.** In the ordinary course of our operations, we enter into certain contractual obligations. Such obligations include operating leases for premises and equipment, agreements with respect to borrowed funds and deposit liabilities and agreements with respect to investments. Except for paying off \$38.3 million of securities sold under agreements to repurchase and a decrease of \$14.7 million in certificates of deposit between December 31, 2011 and September 30, 2012, there have not been any material changes in contractual obligations and funding needs since December 31, 2011.

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

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The following table presents our internal calculations of the estimated changes in our EVE as of June 30, 2012 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                              | \$ 199,297        | \$ (15,860)   | (7.37)%                  | 12.83%   | (0.79)%   |
| +300                              | \$ 219,445        | \$ 4,288  | 1.99%                    | 13.93%   | 0.31%   |
| +200                              | \$ 233,171        | \$ 18,014   | 8.37%                    | 14.64%   | 1.02%   |
| +100                              | \$ 221,736        | \$ 6,579  | 3.06%                    | 14.00%   | 0.38%   |
| 0                                 | \$ 215,157        | \$ 0  | 0.00%                    | 13.62%   | 0.00%   |
| (100)                             | \$ 196,754        | \$ (18,403)   | (8.55)%                  | 12.59%   | (1.03)%   |

- (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 assets.
- (4) EVE Ratio represents EVE divided by the present value of assets.

Interest rates on mortgage-backed securities declined by approximately 82 basis points between June 30, 2012 and September 30, 2012. 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 tables presented assume that the composition of our interest-sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and assume that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration or repricing of specific assets and liabilities. Accordingly, although the EVE tables provide an indication of our interest rate risk exposure at a particular point in time, such measurements are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on our 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, 2012. Based on that evaluation, the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Treasurer, concluded that the Company's disclosure controls and procedures were effective.

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During the quarter ended September 30, 2012, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

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, 2011.

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

(a) Not applicable.

(b) Not applicable.

(c) Stock Repurchases. There were no repurchases of common shares during the quarter ended September 30, 2012. On December 9, 2011, our Board of Directors authorized the repurchase of up to 552,000 shares of our common stock. In accordance with this authorization, we had repurchased 273,461 shares of our common stock as of September 30, 2012. The maximum number of shares that may yet be purchased in the repurchase plan is 278,539. This repurchase authorization originally expired on August 15, 2012, but on August 13, 2012, it was extended to February 15, 2013. We have entered into a 10b5-1 plan with respect to our stock repurchase plan.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

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

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**SIGNATURES**

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

**TERRITORIAL BANCORP INC.**  
(Registrant)

Date: November 8, 2012

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

Date: November 8, 2012

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

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INDEX TO EXHIBITS

| Exhibit<br>Number | Description  |
|-------------------|--|
| 31.1              | Certification of Allan S. Kitagawa, Chairman of the Board, President and Chief Executive Officer, Pursuant to Rule 13a-14(a) and Rule 15d-14(a).   |
| 31.2              | Certification of Melvin M. Miyamoto, Senior Vice President and Treasurer, Pursuant to Rule 13a-14(a) and Rule 15d-14(a).   |
| 32                | Certification of Allan S. Kitagawa, Chairman of the Board, President and Chief Executive Officer, and Melvin M. Miyamoto, Senior Vice President and Treasurer, Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101               | The following financial statements from Territorial Bancorp Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, filed on November 8, 2012, formatted in XBRL: (i) Consolidated Statements of Income, (ii) Consolidated Balance Sheets, (iii) Consolidated Statements of Cash Flows, (iv) Consolidated Statements of Stockholders' Equity and Comprehensive Income, (v) Consolidated Statements of Comprehensive Income and (vi) the Notes to Consolidated Financial Statements. |
| 101.INS           | Interactive datafile                      XBRL Instance Document   |
| 101.SCH           | Interactive datafile                      XBRL Taxonomy Extension Schema Document  |
| 101.CAL           | Interactive datafile                      XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF           | Interactive datafile                      XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB           | Interactive datafile                      XBRL Taxonomy Extension Label Linkbase   |
| 101.PRE           | Interactive datafile                      XBRL Taxonomy Extension Presentation Linkbase Document   |

(1) Incorporated by reference to the Proxy Statement for the 2012 Annual Meeting of Stockholders (file no. 1-34403) filed April 16, 2012.