

Territorial Bancorp Inc.
Form 10-K
April 23, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2013

OR

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

For the transition period from to

Commission File Number: 001-34403

Territorial Bancorp Inc.

(Name of Registrant as Specified in its Charter)

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Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

96813
(Zip Code)

(808) 946-1400

(Registrant's Telephone Number including area code)

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

Common Stock, par value \$0.01 per share

(Title of Class)

The NASDAQ Stock Market LLC

(Name of exchange on which registered)

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

None

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file reports), and (2) has been subject to such requirements for the past 90 days.

(1) YES NO

(2) YES NO

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

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

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company

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

The aggregate value of the voting common equity held by nonaffiliates of the registrant, computed by reference to the closing price of the registrant's shares of common stock as of June 30, 2013 (\$22.61) was \$223.1 million.

As of February 28, 2014, there were 9,880,383 shares outstanding of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2014 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

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FORWARD-LOOKING STATEMENTS

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

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

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

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

- general economic conditions, internationally, nationally or in our market areas, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;

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- 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;

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- the timing and amount of revenues that we may recognize;
- the value and marketability of collateral underlying our loan portfolios;
- the impact of recent legislation to restructure the U.S. financial and regulatory system;
- the quality and composition of our investment portfolio;
- changes in our financial condition or results of operations that reduce capital available to pay dividends; and
- changes in the financial condition or future prospects of issuers of securities that we own.

Because of these and a wide variety of other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements. Please also see Item 1A. Risk Factors.

PART I

ITEM 1. Business

Territorial Bancorp Inc.

Territorial Bancorp Inc. is a Maryland corporation and owns 100% of the outstanding common stock of Territorial Savings Bank. On July 10, 2009, we completed our initial public offering of common stock in connection with the mutual-to-stock conversion of Territorial Mutual Holding Company, selling 12,233,125 shares of common stock at \$10.00 per share and raising \$122.3 million of gross proceeds. Since the completion of our initial public offering, we have not engaged in any significant business activity other than owning the common stock of and having savings deposits in Territorial Savings Bank. At December 31, 2013, we had consolidated assets of \$1.617 billion, consolidated deposits of \$1.289 billion and consolidated stockholders' equity of \$212.1 million.

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

Territorial Savings Bank

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

In November 2013, Territorial Savings Bank filed with the Division of Financial Institutions, State of Hawaii, an application to convert from a federal savings bank to a Hawaii-chartered state savings bank. As part of the charter conversion, the Bank intends to file an application with the Federal Reserve Bank of San Francisco to become a member bank. Territorial Bancorp Inc. will continue to be regulated by the Federal Reserve Board and remain a savings and loan holding company. On February 28, 2014, the Hawaii Commissioner of Financial Institutions approved Territorial Savings Bank's application. The charter conversion remains subject to regulatory approval of the Federal Reserve Bank of San Francisco, and no timetable has been established for the completion of the charter conversion.

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Available Information

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

Our website address is www.territorialsavings.net. Information on our website should not be considered a part of this annual report.

General

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

Market Area

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

The largest sector of Hawaii's economy is the visitor industry. The Hawaii Tourism Authority reported that 8.2 million visitors came to the state in 2013, a 2.6% increase compared to 2012. The increase in visitor arrivals is primarily due to growth in the number of visitors from Canada, Japan and other Asian countries. Total visitor expenditures in 2013 totaled \$14.536 billion, a 2.0% increase compared to 2012.

The unemployment rate for the State of Hawaii was 4.5% in December 2013, representing a decrease from a 5.1% rate in December 2012. This rate continued to be lower than the unemployment rate of 6.7% for the entire United States. The growth in the visitor and construction industries

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have supported the local economy and kept the state's unemployment rate lower than the national rate. The construction of several new condominium projects and work on the City and County of Honolulu's mass transit project has increased employment in Hawaii's construction industry.

The number and median sale prices of existing single-family homes and condominium units sold increased in 2013 compared to 2012. Median home prices in Hawaii have not declined as those reported on the mainland.

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On the island of Oahu, the primary real estate market in Hawaii, sales of existing single-family homes totaled 3,312 units for the year ended December 31, 2013, an increase of 4.6% compared to sales in 2012. The number of condominium sales, a notable portion of the overall housing market, grew by 11.8% in 2013 compared to 2012. The median price paid on Oahu for a single-family home in 2013 was \$650,000, an increase of 4.8% compared to the median price in 2012. The median price paid on Oahu for condominiums in 2013 was \$332,000, an increase of 4.6% compared to the median price in 2012.

On the island of Maui, the second largest real estate market in Hawaii, sales of existing single-family homes totaled 980 units in 2013, an increase of 5.0% compared to similar sales during 2012. The number of condominium sales increased by 6.9% in 2013 compared to 2012. The median price paid for a single-family home on Maui in 2013 was \$530,000, an increase of 12.8% compared to the median price in 2012. The median price paid on Maui for condominiums in 2013 was \$374,500, a 4.3% increase compared to the median price in 2012.

Foreclosure and bankruptcy filings fell in 2013 compared to 2012. There were 3,196 mortgage foreclosure cases in Hawaii in 2013, a 12.0% decrease from 2012. The decrease in foreclosure filings is primarily due to Hawaii's economy growing at a moderate rate. In 2013, there were 2,071 bankruptcy filings, a decrease of 18.1% compared to the number of filings in 2012.

Competition

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

Our deposit sources are primarily concentrated in the communities surrounding our banking offices, located in all four counties in the State of Hawaii. As of June 30, 2013 (the latest date for which information is publicly available), we ranked fifth in deposit market share (out of 13 banks and thrift institutions with offices in Hawaii) in the State of Hawaii, with a 3.7% market share. As of that date, our largest market share was in the City and County of Honolulu, where we ranked fifth in deposit market share (out of 13 banks and thrift institutions with offices in the City and County) with a 3.9% market share.

Lending Activities

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

One- to Four-Family Residential Mortgage Loans. At December 31, 2013, \$823.3 million, or 95.4% of our total loan portfolio, consisted of one- to four-family residential mortgage loans. We offer conforming, fixed-rate and adjustable-rate residential mortgage loans with maturities generally up to 30 years, and to a much more limited extent, of up to 40 years and nonconforming loans with maturities of up to 50 years. There

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has been little demand for adjustable-rate mortgage loans in our market area.

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

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

We will originate loans with loan-to-value ratios in excess of 80%, up to and including a loan-to-value ratio of 100%. We generally require private mortgage insurance for loans with loan-to-value ratios in excess of 80%. During the year ended December 31, 2013, we originated \$17.4 million of one- to four-family residential mortgage loans with loan-to-value ratios in excess of 80%. We offer a variety of credit programs for low- to moderate-income and first-time home purchasers. These include our first time home purchaser program, where the borrower will receive up to a 100 basis point reduction in points charged in connection with the loan. We will also originate first mortgage loans to lower-income individuals who reside in rural census tracts where the U.S. Department of Agriculture will issue a second mortgage and complete the underwriting of the loan, subject to our review before origination. We also offer both FHA and VA fixed-rate loans.

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

Home Equity Loans and Lines of Credit. In addition to traditional one- to four-family residential mortgage loans, we offer home equity loans and home equity lines of credit that are secured primarily by one- to four-family residential homes. Home equity lines of credit have a maximum term of 10 years during which time the borrower is required to make payments to principal based on the amortization of 0.125% of principal outstanding per month. The borrower is permitted to draw against the line during the entire term. Our home equity lines of credit are originated with adjustable rates of interest or with fixed rates of interest that convert to adjustable rates of interest after an initial period of up to three years. Our home equity loans are originated with fixed rates of interest and with terms of up to 30 years. Home equity loans and lines of credit are generally underwritten with the same criteria that we use to underwrite one- to four-family residential mortgage loans. Home equity loans may be underwritten with a loan-to-value ratio of 80% when combined with the principal balance of the existing mortgage loan, while lines of credit for owner-occupied properties and investment properties may be underwritten with loan-to-value ratios of 75% and 65%, respectively, when combined with the principal balance of the existing mortgage loan. We require appraisals on home equity loans and lines of credit when the aggregate loan amount exceeds 60% of the property's tax assessed value or when the home equity loan or line of credit is \$250,000 or greater. When the aggregate loan amount is below 60% of the property's tax assessed value, the tax assessed value must be validated by the Bank's Appraisal Department. At the time we close a home equity loan or line of credit, we record a mortgage to perfect our security interest in the underlying collateral. At December 31, 2013, the outstanding balance of home equity loans totaled \$5.5 million, or 0.6% of our total loan portfolio, and the outstanding balance of home equity lines of credit totaled \$11.0 million, or 1.3% of our total loan portfolio.

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Nonresidential Real Estate Loans. Our nonresidential real estate loans consist primarily of commercial real estate loans and construction loans for residential real estate projects. These loans totaled \$13.6 million, or 1.6% of our loan portfolio as of December 31, 2013. The commercial real estate properties primarily include owner-occupied light industrial properties. We generally seek to originate commercial real estate loans with initial principal balances of \$1.0 million or less. Loans secured by commercial real estate totaled \$7.8 million, or 0.9%, of our total loan portfolio at December 31, 2013, and consisted of 11 loans outstanding with an average loan balance of approximately \$707,000. All of our nonresidential real estate loans are secured by properties located in our primary market area. At December 31, 2013, our largest commercial real estate loan had a principal balance of approximately \$2.0 million and was secured by real property and a building that is being used as an elderly care facility. This loan was performing in accordance with its terms at December 31, 2013.

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

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

We also originate a limited amount of construction loans to experienced developers, almost exclusively for the construction of residential real estate projects. Construction loans are also made to individuals for the construction of their personal residences. Construction loans to individuals are generally interest-only loans during the construction period, and convert to permanent, amortizing loans following the completion of construction. At December 31, 2013, construction loans totaled \$5.0 million, or 0.6% of total loans receivable. At December 31, 2013, the additional unadvanced portion of these construction loans totaled \$4.6 million.

Advances on construction loans are made in accordance with a schedule reflecting the cost of construction, but are generally limited to an 80% loan-to-completed-appraised-value ratio. Repayment of construction loans on residential properties is normally expected from the sale of units to individual purchasers. In the case of income-producing property, repayment is usually expected from permanent financing upon completion of construction. We typically provide the permanent mortgage financing on our construction loans on income-producing property.

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Before making a commitment to fund a construction loan, we require an appraisal of the property by a licensed appraiser. We inspect properties before disbursement of funds during the term of the construction loan.

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

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

Prior to 2010, we retained the servicing rights on residential mortgage loans sold. In 2010, we began selling loans primarily on a servicing-released basis. We sell loans to assist us in managing interest rate risk. We sold \$82.2 million, \$107.9 million and \$61.2 million of residential mortgage loans (all fixed-rate loans, with terms of 10 years or longer) during the years ended December 31, 2013, 2012 and 2011, respectively. We had six loans totaling \$2.2 million classified as held for sale at December 31, 2013.

We sell our loans without recourse, except for normal representations and warranties provided in sales transactions. At December 31, 2013, we were servicing loans owned by others with a principal balance of \$68.4 million. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, contacting delinquent borrowers, supervising foreclosures and property dispositions in the event of unremedied defaults, making certain insurance and tax payments on behalf of the borrowers and generally administering the loans. We retain a portion of the interest paid by the borrower on the loans we service as consideration for our servicing activities. For the year ended December 31, 2013, we received servicing fees of \$213,000. At December 31, 2013, substantially all of the loans serviced for Freddie Mac and Fannie Mae were performing in accordance with their contractual terms and we believe that there are no material repurchase obligations associated with these loans. We have not entered into loan participations in recent years.

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

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

Territorial Savings Bank also uses automated underwriting systems to review one- to four-family residential mortgage loans with balances up to \$625,500. We require appraisals of all real property securing one- to four-family residential real estate loans, and on property securing home equity loans and lines of credit when the aggregate loan amount exceeds 60% of the property's tax assessed value or when the loan or line of credit is \$250,000 or greater. All appraisers are licensed appraisers and all third-party appraisers are approved by the Board of Directors annually.

Investments

Our Board of Directors has primary responsibility for establishing and overseeing our investment policy. The Board of Directors has delegated authority to implement the investment policy to our Investment Committee, consisting of our President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Treasurer and our Vice President and Controller. The investment policy is reviewed at least annually by the Investment Committee, and any changes to the policy are subject to approval by the full Board of Directors. The overall objectives of the Investment Policy are to maintain a portfolio of high quality and diversified investments to maximize interest income over the long term and to minimize risk, to provide collateral for borrowings, to provide additional earnings when loan production is low, and to reduce our tax liability. The policy dictates that investment decisions give consideration to the safety of principal, liquidity requirements and potential returns. Our Senior Vice President and Treasurer executes our securities portfolio transactions as directed by the Investment Committee. All purchase and sale transactions are reported to the Board of Directors on a monthly basis.

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

Our current investment policy does not permit investment in stripped mortgage-backed securities, complex securities and derivatives as defined in federal banking regulations and other high-risk securities. As of December 31, 2013, we held no asset-backed securities other than mortgage-backed securities. As a federal savings bank, Territorial Savings Bank is not permitted to invest in equity securities. This general restriction does not apply to Territorial Bancorp Inc.

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

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

Our securities held to maturity at December 31, 2013 consisted primarily of securities with the following amortized costs: \$586.7 million of mortgage-backed securities, \$26.2 million of collateralized mortgage obligations and \$537,000 of trust preferred securities that were issued by pools of issuers consisting primarily of financial institution holding companies. At December 31, 2013, all of our mortgage-backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac or Ginnie Mae. At December 31, 2013, there were no securities classified as available-for-sale. At December 31, 2013, none of the collateral underlying our securities portfolio was considered subprime or Alt-A, and we did not hold any common or preferred stock issued by Freddie Mac or Fannie Mae as of that date. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Balance Sheet Analysis Securities for a discussion of the recent performance of our securities portfolio. The fair values of our securities are based on published or securities dealers' market values.

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

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Sources of Funds

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

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

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

Borrowings. Our borrowings consist of funds borrowed from securities sold under agreements to repurchase and advances from the Federal Home Loan Bank of Seattle. At December 31, 2013, our securities sold under agreements to repurchase totaled \$72.0 million, or 5.1% of total liabilities, and Federal Home Loan Bank advances totaled \$15.0 million, or 1.1% of total liabilities. At December 31, 2013, we had access to additional Federal Home Loan Bank advances of up to \$375.3 million. Advances from the Federal Home Loan Bank of Seattle are secured by our investment in the common stock of the Federal Home Loan Bank of Seattle as well as by a blanket pledge on our assets not otherwise pledged. Securities sold under agreements to repurchase are secured by mortgage-backed securities.

Subsidiary Activities

Territorial Savings Bank owns 100% of the common stock of Territorial Financial Services, Inc., a Hawaii corporation that engages primarily in insurance activities. At December 31, 2013, Territorial Savings Bank's investment in Territorial Financial Services, Inc. was \$12,000, and Territorial Financial Services, Inc. had assets of \$79,000 at that date. Territorial Savings Bank also owns 100% of the common stock of Territorial Real Estate Co., Inc., an inactive Hawaii corporation that is authorized to manage and dispose of problem real estate.

Personnel

As of December 31, 2013, we had 269 full-time employees and 10 part-time employees. Our employees are not represented by any collective bargaining group. Management believes that we have a good working relationship with our employees.

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FEDERAL AND STATE TAXATION

Federal Taxation

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

Method of Accounting. For federal income tax purposes, Territorial Bancorp Inc. currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31st for filing its consolidated federal income tax returns. The Small Business Protection Act of 1996 eliminated the use of the reserve method of accounting for bad debt reserves by savings institutions, effective for taxable years beginning after 1995.

Minimum Tax. The Internal Revenue Code of 1986, as amended, imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, referred to as alternative minimum taxable income. The alternative minimum tax is payable to the extent alternative minimum taxable income is in excess of an exemption amount. Net operating losses can, in general, offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. At December 31, 2013 and 2012, Territorial Bancorp Inc. had no alternative minimum tax credit carryforward.

Net Operating Loss Carryovers. A financial institution may carry back net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. At December 31, 2013 and 2012, Territorial Savings Bank had no net operating loss carryforward for federal income tax purposes.

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

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

State Taxation

Territorial Bancorp Inc. and Territorial Savings Bank are subject to a franchise tax imposed under Hawaii law at a rate of 7.92% of net income. The net income to which the tax rate is applied is determined in a manner consistent with the taxable income determined for federal purposes

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with some adjustments. The principal adjustment to federal taxable income is the inclusion of interest received on municipal bonds in gross income for Hawaii franchise tax purposes.

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

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SUPERVISION AND REGULATION

General

Territorial Savings Bank is examined and supervised by the Office of the Comptroller of the Currency and is subject to examination by the Federal Deposit Insurance Corporation. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the Federal Deposit Insurance Corporation's deposit insurance fund and depositors, and not for the protection of security holders. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. Territorial Savings Bank also is regulated to a lesser extent by the Board of Governors of the Federal Reserve System, or Federal Reserve Board, governing reserves to be maintained against deposits and other matters. The Office of the Comptroller of the Currency examines Territorial Savings Bank and prepares reports for the consideration of the Bank's Board of Directors on any operating deficiencies. Territorial Savings Bank's relationship with its depositors and borrowers also is regulated to a great extent by federal law and, to a much lesser extent, state law, especially in matters concerning the ownership of deposit accounts and the form and content of Territorial Savings Bank's loan documents.

Any change in these laws or regulations, whether by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency or Congress, could have a material adverse impact on Territorial Bancorp Inc., Territorial Savings Bank and their operations.

Territorial Bancorp Inc., as a savings and loan holding company, is required to file certain reports with, is subject to examination by, and otherwise must comply with the rules and regulations of the Federal Reserve Board. Territorial Bancorp Inc. is also subject to the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

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

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

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

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such laws and regulations by the Office of the Comptroller of the Currency, its primary banking regulator, rather than the Consumer Financial Protection Bureau.

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

In November 2013, Territorial Savings Bank filed with the Division of Financial Institutions, State of Hawaii, an application to convert from a federal savings bank to a Hawaii-chartered state savings bank. As part of the charter conversion, the Bank intends to file an application with the Federal Reserve Bank of San Francisco to become a member bank. Territorial Bancorp Inc. will continue to be regulated by the Federal Reserve Board and remain a savings and loan holding company. On February 28, 2014, the Hawaii Commissioner of Financial Institutions approved Territorial Savings Bank's application. The charter conversion remains subject to regulatory approval of the Federal Reserve Bank of San Francisco, and no timetable has been established for the completion of the charter conversion.

Federal Banking Regulation

Business Activities. A federal savings bank derives its lending and investment powers from the Home Owners Loan Act, as amended, and the regulations of the Office of the Comptroller of the Currency. Under these laws and regulations, Territorial Savings Bank may invest in mortgage loans secured by residential and commercial real estate, commercial business and consumer loans, certain types of investment securities and certain other assets, subject to applicable limits. Territorial Savings Bank also may establish subsidiaries that may engage in activities not otherwise permissible for Territorial Savings Bank, including real estate investment and securities and insurance brokerage. In addition, the Dodd-Frank Act authorized the payment of interest on commercial checking accounts, effective July 21, 2011.

Capital Requirements. Federal regulations require savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for savings banks receiving the highest rating on the CAMELS rating system) and an 8% risk-based capital ratio.

The risk-based capital standard for savings banks requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, based on the risks believed inherent in the type of asset. Core capital is defined as common stockholders' equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of

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risk-weighted assets and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital. Additionally, a savings bank that retains credit risk in connection with an asset sale may be required to maintain additional regulatory capital because of the recourse back to the savings bank. In assessing an institution's capital adequacy, the Office of the Comptroller of the Currency takes into consideration not only these numeric factors but also qualitative factors as well, and has the authority to establish higher capital requirements for individual associations where necessary.

In July 2013, the Office of the Comptroller of the Currency and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain available-for-sale securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt-in or opt-out is exercised. The rule limits a banking organization's capital distributions and certain discretionary bonus payments to executive officers if the banking organization does not hold a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule also implements the Dodd-Frank Act's directive to apply to savings and loan holding companies consolidated capital requirements that are not less stringent than those applicable to their subsidiary institutions. The final rule is effective January 1, 2015. The capital conservation buffer will be phased in from January 1, 2016 to January 1, 2019, when the full capital conservation buffer will be effective.

At December 31, 2013, Territorial Savings Bank's regulatory capital exceeded all applicable requirements.

Loans-to-One Borrower. Generally, a federal savings bank may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2013, Territorial Savings Bank's largest lending relationship with a single or related group of borrowers totaled \$4.7 million, which represented 2.4% of unimpaired capital and surplus. Therefore, Territorial Savings Bank was in compliance with the loans-to-one borrower limitations.

Qualified Thrift Lender Test. As a federal savings bank, Territorial Savings Bank must satisfy the qualified thrift lender, or QTL, test. Under the QTL test, Territorial Savings Bank must maintain at least 65% of its portfolio assets in qualified thrift investments (primarily residential mortgages and related investments, including mortgage-backed securities) in at least nine months of the most recent 12-month period. Portfolio assets generally means total assets of a savings institution, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the savings bank's business.

Territorial Savings Bank also may satisfy the QTL test by qualifying as a domestic building and loan association as defined in the Internal Revenue Code. A savings bank that fails the qualified thrift lender test must operate under specified restrictions set forth in the Home Owners Loan Act. Additionally, the Dodd-Frank Act made noncompliance with the QTL test potentially subject to agency enforcement action for violation of law.

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At December 31, 2013, Territorial Savings Bank maintained approximately 95.6% of its portfolio assets in qualified thrift investments and, therefore, satisfied the QTL test.

Capital Distributions. Office of the Comptroller of the Currency or Federal Reserve regulations govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the savings bank's capital account. A savings bank must file an application for approval of a capital distribution if:

- the total capital distributions for the applicable calendar year exceed the sum of the savings bank's net income for that year to date plus the savings bank's retained net income for the preceding two years;
- the savings bank would not be at least adequately capitalized following the distribution;
- the distribution would violate any applicable statute, regulation, agreement or Office of the Comptroller of the Currency-imposed condition; or
- the savings bank is not eligible for expedited treatment of its filings.

Even if an application is not otherwise required, every savings bank that is a subsidiary of a holding company must still file a notice with the Federal Reserve Board at least 30 days before the Board of Directors declares a dividend or approves a capital distribution.

The Federal Reserve Board, upon consultation with the Office of the Comptroller of the Currency, may disapprove a notice or application if:

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

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

Liquidity. A federal savings bank is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation. Our primary source of liquidity to meet our short- and long-term funding needs are cash balances at the Federal Reserve Bank, savings deposits, loan and security repayments, loan and security sales, securities sold under agreements to repurchase with security dealers and borrowing lines at the Federal Home Loan Bank of Seattle. At December 31, 2013, Territorial Savings Bank had \$75.4 million of cash and cash equivalents. We also had the capacity to borrow up to \$375.3 million from the Federal Home Loan Bank of Seattle at December 31, 2013.

Community Reinvestment Act and Fair Lending Laws. All savings banks have a responsibility under the Community Reinvestment Act and related federal regulations to help meet the credit needs of their communities, including low- and moderate-income borrowers. In connection with its examination

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of a federal savings bank, the Office of the Comptroller of the Currency is required to assess the savings bank's record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A savings bank's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in denial of certain corporate applications such as branches or mergers, or in restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the Office of the Comptroller of the Currency, as well as other federal regulatory agencies and the Department of Justice. The Community Reinvestment Act requires all Federal Deposit Insurance Corporation-insured institutions to publicly disclose their rating. Territorial Savings Bank received a satisfactory Community Reinvestment Act rating in its most recent federal examination.

Transactions with Related Parties. A federal savings bank's authority to engage in transactions with its affiliates is limited by Office of the Comptroller of the Currency regulations and by Sections 23A and 23B of the Federal Reserve Act and its implementing Regulation W promulgated by the Board of Governors of the Federal Reserve System. An affiliate is generally a company that controls, is controlled by, or is under common control with an insured depository institution such as Territorial Savings Bank. Territorial Bancorp Inc. is an affiliate of Territorial Savings Bank. In general, transactions between an insured depository institution and its affiliates are subject to certain quantitative and collateral requirements. In addition, Office of the Comptroller of the Currency regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary. Finally, transactions with affiliates must be consistent with safe and sound banking practices, not involve low-quality assets and be on terms that are as favorable to the institution as comparable transactions with nonaffiliates. The Office of the Comptroller of the Currency requires savings banks to maintain detailed records of all transactions with affiliates.

Territorial Savings Bank's authority to extend credit to its directors, executive officers and 10% stockholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders:

(i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, and

(ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of Territorial Savings Bank's capital.

In addition, extensions of credit in excess of certain limits must be approved by Territorial Savings Bank's Board of Directors.

Enforcement. The Office of the Comptroller of the Currency has primary enforcement responsibility over federal savings institutions and has the authority to bring enforcement action against all institution-affiliated parties, including directors, officers, stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action by the Office of the Comptroller of the Currency may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors of the institution, and the appointment of a receiver or conservator. Civil penalties cover a wide

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range of violations and actions, and range up to \$25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as \$1 million per day. The Federal Deposit Insurance Corporation also has the authority to terminate deposit insurance or to recommend to the Office of the Comptroller of the Currency that enforcement action be taken with respect to a particular savings institution. If action is not taken by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation has authority to take action under specified circumstances.

The Office of the Comptroller of the Currency has assumed the Office of Thrift Supervision's enforcement authority under the Dodd-Frank Act regulatory restructuring.

Standards for Safety and Soundness. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. Interagency guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to implement an acceptable compliance plan. Failure to implement such a plan can result in further enforcement action, including the issuance of a cease and desist order or the imposition of civil money penalties.

Prompt Corrective Action Regulations. Under prompt corrective action regulations, the Office of the Comptroller of the Currency is authorized and, under certain circumstances, required to take supervisory actions against undercapitalized savings banks. For this purpose, a savings bank is placed in one of the following five categories based on the savings bank's capital:

- well-capitalized (at least 5% leverage capital, 6% Tier 1 risk-based capital and 10% total risk-based capital);

- adequately capitalized (at least 4% leverage capital (3% for savings banks with a composite examination rating of 1), 4% Tier 1 risk-based capital and 8% total risk-based capital);

- undercapitalized (less than 4% leverage capital (3% for savings banks with a composite examination rating of 1), 4% Tier 1 risk-based capital or 8% total risk-based capital);

- significantly undercapitalized (less than 3% leverage capital, 3% Tier 1 risk-based capital or 6% total risk-based capital); and

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

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Generally, the Office of the Comptroller of the Currency is required to appoint a receiver or conservator for a savings bank that is critically undercapitalized within specific time frames. The regulations also provide that a capital restoration plan must be filed with the Office of the Comptroller of the Currency within 45 days of the date a savings bank receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Any holding company for the savings bank required to submit a capital restoration plan must guarantee the lesser of an amount equal to 5% of the savings bank's assets at the time it was notified or deemed to be undercapitalized by the Office of the Comptroller of the Currency, or the amount necessary to restore the savings bank to adequately

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capitalized status. This guarantee remains in place until the Office of the Comptroller of the Currency notifies the savings bank that it has maintained adequately capitalized status for each of four consecutive calendar quarters, and the Office of the Comptroller of the Currency has the authority to require payment and collect payment under the guarantee. Failure by a holding company to provide the required guarantee will result in certain operating restrictions on the savings bank, such as restrictions on the ability to declare and pay dividends, pay executive compensation and management fees, and increase assets or expand operations. The Office of the Comptroller of the Currency may also take any one of a number of discretionary supervisory actions against undercapitalized associations, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At December 31, 2013, Territorial Savings Bank met the criteria for being considered well-capitalized.

In connection with the final capital rule described earlier, the federal banking agencies have adopted revisions, effective January 1, 2015, to the prompt corrective action framework. Under the revised prompt corrective action requirements, insured depository institutions would be required to meet the following in order to qualify as well capitalized: (1) a common equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (3) a total risk-based capital ratio of 10% (unchanged from current rules) and (4) a Tier 1 leverage ratio of 5% (unchanged from the current rules).

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

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

Assessment rates previously ranged from seven to 77.5 basis points of assessable deposits. The Dodd-Frank Act required the Federal Deposit Insurance Corporation to revise its procedures to base its assessments upon total assets less tangible equity instead of deposits. The Federal Deposit Insurance Corporation finalized a rule, effective April 1, 2011, that changed the assessment range to 2.5 to 45 basis points of total assets less tangible equity.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. That payment is established quarterly and during the quarter ended December 31, 2013, equaled 0.64 basis points of total assets less tangible capital.

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

exercised that discretion by establishing a long-range fund ratio of 2%.

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

Prohibitions Against Tying Arrangements. Federal savings banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

Federal Home Loan Bank System. Territorial Savings Bank is a member of the Federal Home Loan Bank System, which consists of twelve regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions as well as other entities involved in home mortgage lending. As a member of the Federal Home Loan Bank of Seattle, Territorial Savings Bank is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of December 31, 2013, Territorial Savings Bank held \$11.7 million of capital stock in the Federal Home Loan Bank of Seattle and was in compliance with this requirement.

Other Regulations

Interest and other charges collected or contracted for by Territorial Savings Bank are subject to state usury laws and federal laws concerning interest rates. Territorial Savings Bank's operations are also subject to federal laws applicable to credit transactions, such as the:

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

- Real Estate Settlement Procedures Act, requiring that borrowers for mortgage loans for one- to four-family residential real estate receive various disclosures, including good faith estimates of settlement costs, lender servicing and escrow account practices, and prohibiting certain practices that increase the cost of settlement services;

- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;

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- fair lending laws;
- Unfair or Deceptive Acts or Practices (UDAP) laws and regulations;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;

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- Truth in Savings Act; and
- rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

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

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

Holding Company Regulation

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

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supervising savings and loan holding companies from the Office of Thrift Supervision to the Federal Reserve Board, effective July 21, 2011.

Permissible Activities. The business activities of Territorial Bancorp Inc. are generally limited to those activities permissible for financial holding companies under Section 4(k) of the Bank Holding Company Act of 1956, as amended, or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance as well as activities that are incidental to financial activities or complementary to

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a financial activity. The Dodd-Frank Act added that any savings and loan holding company that engages in activities permissible for a financial holding company must meet the qualitative requirements for a bank holding company to be a financial holding company and conduct the activities in accordance with the requirements that would apply to a financial holding company's conduct of the activity. A multiple savings and loan holding company is generally limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the Federal Reserve Board, and certain additional activities authorized by Federal Reserve Board regulations.

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

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

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

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

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

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

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

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

Change in Control Regulations

Under the Change in Bank Control Act, no person may acquire control of a savings and loan holding company such as the Company unless the Federal Reserve Board has been given 60 days' prior written notice and has not issued a notice disapproving the proposed acquisition, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Control, as defined under federal law, means ownership, control of or holding irrevocable proxies representing more than 25% of any class of voting stock, control in any manner of the election of a majority of the company's directors, or a determination by the regulator that the acquirer has the power to direct, or directly or indirectly to exercise a controlling influence over, the management or policies of the institution. Acquisition of more than 10% of any class of a savings and loan holding company's voting stock constitutes a rebuttable presumption of control under the regulations under certain circumstances including where, as is the case with Territorial Bancorp Inc., the issuer has registered securities under Section 12 of the Securities Exchange Act of 1934.

Federal Securities Laws

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

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

Sarbanes-Oxley Act of 2002

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

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ITEM 1A. Risk Factors

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

During the past six years it has been the policy of the Federal Reserve Board to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of mortgage-backed securities. As a result, interest rates on the loans we have originated and the yields on securities we have purchased have been at lower levels than available prior to 2008. As a general matter, our interest-bearing liabilities reprice or mature more quickly than our interest-earning assets, which has been one factor contributing to the increase in our interest rate spread as interest rates decreased. However, our ability to lower our interest expense will be limited since our cost of funds at December 31, 2013 is relatively low while the average yield on our interest-earning assets may continue to decrease as our higher yielding loans and securities are paid off. The Federal Reserve Board has previously indicated its intention to maintain low interest rates until the unemployment rate is 6.5% or lower. Accordingly, our net interest income may be adversely affected and may even decrease, which may have an adverse effect on our profitability.

Future changes in interest rates could reduce our profits.

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

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

As a result of our focus on one- to four-family residential real estate loans and the low demand for adjustable-rate loans in our market area, the interest rates we earn on our loans are generally fixed for long periods of time. Additionally, many of our securities investments are of long maturities with fixed interest rates. Like many savings institutions, our focus on deposit accounts as a source of funds, which have no stated maturity date or shorter contractual maturities than loans, results in our liabilities having a shorter duration than our assets. For example, as of December 31, 2013, 92.0% of our loans had maturities of 15 years or longer, while 72.8% of our certificates of deposits had maturities of one year or less. This imbalance can create significant earnings volatility, because market interest rates change over time. In a period of rising interest rates, the interest income earned on our assets, such as loans and investments, likely will not increase as rapidly as the interest paid on our liabilities, such as deposits. In a period of declining interest rates, the interest income earned on our assets likely will decrease more rapidly than the interest paid on our liabilities, as borrowers prepay mortgage loans and mortgage-backed securities, thereby requiring us to reinvest these cash flows at lower interest rates. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Management of Market Risk.

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

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Changes in interest rates also affect the current fair value of our interest-earning securities portfolio. Generally, the value of securities moves inversely with changes in interest rates. At December 31, 2013, the fair value of our investment in held-to-maturity securities totaled \$598.0 million. Net unrealized losses on these securities totaled \$15.4 million at December 31, 2013.

At December 31, 2013, our rate shock analysis indicated that our economic value of equity (the difference between the market value of our assets and the market value of our liabilities with adjustments made for off-balance sheet items) would decrease by \$56.9 million if there was an instantaneous 200 basis point increase in market interest rates. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Management of Market Risk.

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

Our principal lending activity consists of originating one- to four-family residential real estate mortgage loans. As of December 31, 2013, these loans totaled \$823.3 million or 95.4% of total loans. We originate our loans with a focus on limiting credit risk and not to generate the highest return or create the greatest difference between the yield on our interest-earning assets and our cost of funds (interest rate spread).

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

We could record future losses on our holdings of trust preferred securities that we purchased from issuer pools consisting primarily of financial institution holding companies. In addition, we may not receive full future principal or interest payments, or both, on these securities.

We owned shares of trust preferred securities with an adjusted cost basis and fair value of \$537,000 at December 31, 2013. The trust preferred securities are debt obligations issued by two issuer pools (Preferred Term Securities XXIII, Ltd. co-marketed by Keefe, Bruyette & Woods, Inc. and FTN Financial Capital Markets (PreTSL XXIII) and Preferred Term Securities XXIV, Ltd. co-marketed by Keefe, Bruyette & Woods, Inc. and FTN Financial Capital Markets (PreTSL XXIV)), consisting primarily of holding companies for Federal Deposit Insurance Corporation-insured financial institutions. Each of these securities is a Class D security, and was originated with a credit rating of BBB. As of December 31, 2013, both PreTSL XXIII and PreTSL XXIV were rated C by Fitch. PreTSL XXIV has a book value of \$0.

Our investment in PreTSL XXIII was determined to be other-than-temporarily impaired as the present value of cash flows was lower than the amortized cost basis of the security. We recorded an impairment charge of \$2.4 million in the year ended December 31, 2010. When the impairment charge of \$2.4 million on PreTSL XXIII was recorded, the security was written down to its fair value of \$32,000. The book value of our investment in PreTSL XXIII has risen from \$32,000 to \$537,000 based on an increase in fair value which has occurred with an increase in the present value of cash flows from this security. The \$1.1 million difference between the original outstanding principal balance of \$3.5 million and the impairment charge of \$2.4 million was reported as other comprehensive loss and is related to noncredit factors such as an inactive trust preferred securities market.

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

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

For the year ended December 31, 2013, we received no interest payments on the trust preferred securities. The continued failure of the trust preferred issuers to make interest payments for any quarter will reduce our earnings during that quarter.

The following table sets forth information with respect to these securities as of December 31, 2013:

Pool Deal Name	Book Value	Fair Value	Unrealized Gain	Credit Rating	Number of Financial Institutions in Pool	Deferrals and Defaults as a % of Collateral		Excess Subordination (1)
PreTSL XXIII	\$ 537	\$ 537	\$	C	106	24.2%	\$	
PreTSL XXIV	\$	\$	\$	C	79	35.4%	\$	

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

Recent regulations could require changes to our investment strategies.

Effective December 10, 2013, pursuant to the Dodd-Frank Act, federal banking and securities regulators issued final rules to implement Section 619 of the Dodd-Frank Act (the Volcker Rule). Generally, subject to a transition period and certain exceptions, the Volcker Rule restricts insured depository institutions and their affiliated companies from engaging in short-term proprietary trading of certain securities, investing in funds with collateral comprised of less than 100% loans where the funds are not registered with the Securities and Exchange Commission and from engaging in hedging activities that do not hedge a specific identified risk. After the transition period, the Volcker Rule prohibitions and restrictions will apply to banking entities unless an exception applies. We have analyzed the impact of the Volcker Rule on our investment portfolio, and we believe no changes are required to our investment strategies that would negatively affect our earnings.

A continuation or worsening of prevailing economic conditions could adversely affect our financial condition and results of operations.

Although the U.S. economy has emerged from the severe recession that occurred in 2008 and 2009, economic growth has been slow and unemployment levels remain high despite the Federal Reserve Board's unprecedented efforts to maintain low market interest rates and encourage economic growth. Recovery by many businesses has been impaired by lower consumer spending. A discontinuation of the Federal Reserve Board's bond purchasing program could result in higher interest rates and reduced economic activity. Moreover, a return to prolonged deteriorating economic conditions could significantly affect the markets in which we do business, the value of our loans and investments, and our ongoing

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operations, costs and profitability. Declines in real estate values and sales volumes and increases in unemployment levels may result in greater loan delinquencies, increases in our nonperforming, criticized and classified assets and a decline in demand for our products and services. These events may cause us to incur losses and may adversely affect our financial condition and results of operations.

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

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

The potential exists for additional federal or state laws and regulations, or changes in policy, regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Bank regulatory agencies, such as the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, govern the activities in which we may engage, primarily for the protection of depositors, and not for the protection or benefit of potential investors. In addition, new laws, regulations and other regulatory changes may increase our costs of regulatory compliance and of doing business, and otherwise affect our operations. New laws, regulations, and other regulatory changes may significantly affect the markets in which we do business, the markets for and value of our loans and investments, and our ongoing operations, costs and profitability. Federal and state proposals limiting our rights as a creditor could result in credit losses or increased expense in pursuing our remedies as a creditor.

The Federal Home Loan Bank of Seattle has entered into a consent order with the Federal Housing Finance Agency. If our investment in the Federal Home Loan Bank of Seattle is classified as other-than-temporarily impaired or as permanently impaired, our earnings and stockholders' equity could decrease.

We own common stock of the Federal Home Loan Bank of Seattle (FHLB of Seattle). We hold this stock to qualify for membership in the Federal Home Loan Bank System and to be eligible to borrow funds under the FHLB of Seattle's advance program. The aggregate cost and fair value of our FHLB of Seattle common stock as of December 31, 2013 was \$11.7 million based on its par value. There is no market for our FHLB of Seattle common stock.

On October 25, 2010, the FHLB of Seattle entered into a consent order with the Federal Housing Finance Agency (FHFA), which requires the FHLB of Seattle to take certain specified actions related to its business and operations. In September 2012, FHFA reclassified the FHLB of Seattle as adequately capitalized and the FHLB of Seattle began to repurchase a limited amount of member capital stock at par. In July 2013, the FHLB of Seattle started to pay limited dividends. The FHLB of Seattle may again be in position to redeem certain capital stock from members in larger amounts and pay higher dividends once the bank:

- achieves and maintains certain other financial and operational metrics;

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- remediates certain concerns regarding its oversight and management, asset improvement program, capital adequacy and retained earnings, risk management, compensation practices, examination findings, and information technology; and
- returns to a safe and sound condition as determined by the FHFA.

Any stock repurchases and redemptions and dividend payments by the FHLB of Seattle will be subject to FHFA approval.

There continues to be a risk that the FHLB of Seattle may not be permitted to redeem certain capital stock from members and pay dividends in the future, and that our investment in FHLB of Seattle common stock could be impaired at some time in the future. If this occurs, it would cause our earnings and stockholders' equity to decrease by the after-tax amount of the impairment charge.

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

At December 31, 2013, our portfolio of commercial real estate, construction and other nonresidential real estate loans totaled \$13.6 million, or 1.6% of total loans. In addition, at December 31, 2013, our portfolio of commercial business loans totaled \$3.6 million, or 0.4% of total loans. These loans generally expose us to a greater risk of nonpayment and loss than residential real estate loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential real estate loans.

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

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

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

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

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, resulting in additions to our allowance. While our allowance for loan losses was 0.2% of total loans at December 31, 2013, material additions to our allowance could materially decrease our net income.

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

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

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

Our 2010 Equity Incentive Plan will increase our expenses and reduce our income, and may dilute your ownership interests.

In August 2010, our stockholders approved the Territorial Bancorp Inc. 2010 Equity Incentive Plan. Stockholders approved the issuance of 736,434 shares of common stock pursuant to restricted stock and the issuance of 976,203 shares of common stock pursuant to stock options. During 2013, we recognized \$2.7 million in noninterest expense relating to this stock benefit plan and we expect to incur similar expenses in the future.

We may fund the 2010 Equity Incentive Plan either through open market purchases or from the issuance of authorized but unissued shares of common stock. Our ability to repurchase shares of common stock to fund this plan will be subject to many factors, including, but not limited to, applicable regulatory restrictions on stock repurchases, the availability of stock in the market, the trading price of the stock, our capital levels, alternative uses for our capital and our financial performance. Our intention is to fund the plan through open market purchases and we have repurchased 2,528,259 shares as of December 31, 2013. However, stockholders would experience a reduction in ownership interest in the event newly issued shares of our common stock are used to fund stock options and shares of restricted common stock.

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

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

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

Tourism is the largest sector of Hawaii's economy. The Hawaii Tourism Authority reported visitor arrivals and visitor spending grew by 2.6% and 2.0%, respectively, in 2013 compared to 2012. A downturn in the tourism industry, and the related loss of jobs or operating income for businesses, could have a significant impact on our ability to originate loans, and the ability of borrowers to repay loans, either of which could adversely affect our financial condition and results of operations.

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

Defense spending represents a significant portion of Hawaii's economy. Proposals to cut defense and other general spending could have an adverse impact on Hawaii's economy, which could adversely affect our financial condition and results of operations.

We are subject to extensive regulatory oversight.

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

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

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

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Financial reform legislation has, among other things, eliminated the Office of Thrift Supervision and created a new Consumer Financial Protection Bureau and will result in new laws and regulations that are expected to increase our costs of operations.

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

As a result of the Dodd-Frank Act, the Office of the Comptroller of the Currency became the primary federal regulator for federal thrifts (replacing the Office of Thrift Supervision), and the Board of Governors of the Federal Reserve System now supervises and regulates all savings and loan holding companies that were formerly regulated by the Office of Thrift Supervision, including Territorial Bancorp Inc.

The Dodd-Frank Act also broadened the base for Federal Deposit Insurance Corporation insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor.

The Dodd-Frank Act requires publicly-traded companies to give stockholders a nonbinding vote on executive compensation and so-called golden parachute payments. The legislation also directs the Federal Reserve Board to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded or not.

The Dodd-Frank Act created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit unfair, deceptive or abusive acts and practices. Banks and savings institutions with \$10 billion or less in assets, like Territorial Savings Bank, are examined by their applicable bank regulators. The Dodd-Frank Act also weakens the federal preemption rules that have been applicable for national banks and federal savings associations, and gives state attorneys general the ability to enforce federal consumer protection laws.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense.

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

In July 2013, the FDIC and the Federal Reserve Board approved a new rule that will substantially amend the regulatory risk-based capital rules. The final rule implements the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

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The final rule includes new minimum risk-based capital and leverage ratios, which will be effective for us on January 1, 2015, and refines the definition of what constitutes capital for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total

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capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a capital conservation buffer of 2.5%, and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 to risk-based assets capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions.

We have analyzed the effects of these new capital requirements, and we believe that Territorial Savings Bank and Territorial Bancorp Inc. would meet all of these new requirements, including the full 2.5% capital conservation buffer, as if these new requirements had been in effect as of December 31, 2013.

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

Our ability to originate mortgage loans may be adversely affected by the restructuring of Freddie Mac and Fannie Mae.

Both Fannie Mae and Freddie Mac are under conservatorship with the Federal Housing Finance Agency, an agency of the U.S. government. On February 11, 2011, the Obama administration presented the U.S. Congress with a report of its proposals for reforming America's housing finance market with the goal of scaling back the role of the U.S. government in, and promoting the return of private capital to, the mortgage markets and ultimately winding down Fannie Mae and Freddie Mac. Without mentioning a specific time frame, the report calls for the reduction of the role of Fannie Mae and Freddie Mac in the mortgage markets by, among other things, reducing conforming loan limits, increasing guarantee fees and requiring larger down payments by borrowers. The report presents three options for the long-term structure of housing finance, all of which call for the unwinding of Fannie Mae and Freddie Mac and a reduced role of the government in the mortgage market: (i) a system with U.S. government insurance limited to a narrowly targeted group of lower- and moderate-income borrowers; (ii) a system similar to (i) above except with an expanded guarantee during times of crisis; and (iii) a system where the U.S. government offers reinsurance for the securities of a broad range of mortgages behind significant private capital. We cannot be certain if or when Fannie Mae and Freddie Mac will be wound down, if or when reform of the housing finance market will be implemented or what the future role of the U.S. government will be in the mortgage market, and, accordingly, we will not be able to determine the impact that any such reform may have on us until a definitive reform plan is adopted.

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

Newly enacted financial reform legislation has changed the bank regulatory framework, creating an independent consumer protection bureau that will assume the consumer protection responsibilities of the various federal banking agencies, and establish more stringent capital standards for banks and bank holding companies. The legislation has resulted in new regulations affecting the lending, funding, trading and investment

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activities of banks and bank holding companies. Bank regulatory agencies also have been responding aggressively to concerns and adverse trends identified in examinations. Ongoing uncertainty and adverse developments in the financial services industry and the domestic and international credit markets, and the effect of new legislation and regulatory actions in response to these conditions, may adversely affect our operations by restricting our business activities, including our ability to originate or sell loans, modify loan terms, or foreclose on property securing loans. These measures are likely to increase our costs of doing business and may have a significant adverse effect on our lending activities, financial performance and operating flexibility. In addition, these risks could affect the performance and value of our loan and investment securities portfolios, which also would negatively affect our financial performance.

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

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions.

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

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

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

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

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

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

Our risk management framework is designed to minimize risk and loss to us. We seek to identify, measure, monitor, report and control our exposure to risk, including strategic, market, liquidity, compliance and operational risks. While we use a broad and diversified set of risk monitoring and mitigation techniques, these techniques are inherently limited because they cannot anticipate the existence

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or future development of currently unanticipated or unknown risks. Recent economic conditions and heightened legislative and regulatory scrutiny of the financial services industry, among other developments, have increased our level of risk. Accordingly, we could suffer losses as a result of our failure to properly anticipate and manage these risks.

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

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

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

We are a community bank, and our reputation is one of the most valuable components of our business. A key component of our business strategy is to rely on our reputation for customer service and knowledge of local markets to expand our presence by capturing new business opportunities from existing and prospective customers in our current market and contiguous areas. As such, we strive to conduct our business in a manner that enhances our reputation. This is done, in part, by recruiting, hiring and retaining employees who share our core values of being an integral part of the communities we serve, delivering superior service to our customers and caring about our customers and associates. If our reputation is negatively affected, by the actions of our employees, by our inability to conduct our operations in a manner that is appealing to current or prospective customers, or otherwise, our business and operating results may be adversely affected.

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

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

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Proposed and final regulations could restrict our ability to originate and sell loans.

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

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

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

In addition, the Dodd-Frank Act requires the regulatory agencies to issue regulations that require securitizers of loans to retain not less than 5% of the credit risk for any asset that is not a qualified residential mortgage. The regulatory agencies have issued a proposed rule to implement this requirement. The Dodd-Frank Act provides that the definition of qualified residential mortgage can be no broader than the definition of qualified mortgage issued by the Consumer Financial Protection Bureau for purposes of its regulations.

Although the final rule with respect to the retention of credit risk has not yet been issued, the final rule could have a significant effect on the secondary market for loans and the types of loans we originate, and restrict our ability to make loans. Similarly, the Consumer Financial Protection Bureau's rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, which could limit our growth or profitability.

ITEM 1B. Unresolved Staff Comments

Not applicable.

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We operate from our corporate office in Honolulu, Hawaii, and from our 28 full-service branches located in the State of Hawaii. The net book value of our premises, land and equipment was \$6.1 million at December 31, 2013. The following table sets forth information with respect to our full-service banking offices, including the expiration date of leases with respect to leased facilities.

AINA HAINA Aina Haina Shopping Center 820 West Hind Drive Honolulu, Oahu 96821 4/30/2021	KAILUA 19 Oneawa Street Kailua, Oahu 96734	KAUAI Kukui Grove Shopping Center 4393 Kukui Grove Street Lihue, Kauai 96766 2/28/2018	NUUANU Nuuanu Shopping Center 1613 Nuuanu Avenue Honolulu, Oahu 96817 7/22/2021
ALA MOANA CENTER 1450 Ala Moana Boulevard Honolulu, Oahu 96814 12/31/2017	KAIMUKI 1108 12th Avenue Honolulu, Oahu 96816 12/31/2018	KIHEI Azeka Shopping Center 1279 South Kihei Road Kihei, Maui 96753 1/31/2019	PEARL CITY Pearl City Shopping Center 850 Kamehameha Highway Pearl City, Oahu 96782 9/22/2014
DOWNTOWN 1000 Bishop Street Honolulu, Oahu 96813 12/31/2020	KALIHI-KAPALAMA 1199 Dillingham Boulevard Honolulu, Oahu 96817 8/31/2017	KONA Crossroads Shopping Center 75-1027 Henry Street Kailua-Kona, Hawaii 96740 8/31/2015	PEARLRIDGE 98-084 Kamehameha Highway Aiea, Oahu 96701 6/30/2022
HAWAII KAI Hawaii Kai Shopping Center 377 Keahole Street Honolulu, Oahu 96825 9/30/2018	KAMEHAMEHA SHOPPING CENTER 1620 North School Street Honolulu, Oahu 96817 9/30/2015	LAHAINA Old Lahaina Center 170 Papalaua Street Lahaina, Maui 96761 3/31/2023	PIIKOI 1159 South Beretania Street Honolulu, Oahu 96814 12/31/2020
HILO Waiakea Center 315 Makaala Street Hilo, Hawaii 96720 12/31/2018	KANEOHE 46-005 Kawa Street Kaneohe, Oahu 96744 12/31/2014	MANOA Manoa Marketplace 2752 Woodlawn Drive Honolulu, Oahu 96822 7/10/2023	SALT LAKE Salt Lake Shopping Center 848 Ala Liliko'i Street Honolulu, Oahu 96818 1/31/2016
KAHALA 4819 Kilauea Avenue Honolulu, Oahu 96816 3/16/2015	KAPAHULU Kilohana Square 1016 Kapahulu Avenue Honolulu, Oahu 96816 11/14/2018	McCULLY 1111 McCully Street Honolulu, Oahu 96826 5/31/2018	WAIPAHU Waipahu Town Center 94-050 Farrington Highway Waipahu, Oahu 96797 12/31/2014
KAHULUI Queen Kaahumanu Center 275 W. Kaahumanu Avenue Kahului, Maui 96732 12/31/2019	KAPOLEI Ace Center at Kapolei 480 Kamokila Boulevard Kapolei, Oahu 96709 7/31/2014	MILILANI Town Center of Mililani 95-1249 Meheula Parkway Mililani, Oahu 96789 10/11/2014	WAIPIO Laniakea Plaza 94-1221 Ka Uka Boulevard Waipahu, Oahu 96797 9/30/2016

ITEM 3. Legal Proceedings

From time to time, we are involved as plaintiff or defendant in various legal proceedings arising in the ordinary course of business. Except as previously disclosed, at December 31, 2013, we were not involved in any legal proceedings, the outcome of which we believe would be material to our financial condition or results of operations.

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Not applicable.

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

(a) **Market, Holder and Dividend Information.** Our common stock is traded on the NASDAQ Global Select Market under the symbol TBNK. The approximate number of holders of record of Territorial Bancorp Inc.'s common stock as of February 28, 2014 was 1,271. Certain shares of Territorial Bancorp Inc. are held in nominee or street name and, accordingly, the number of beneficial owners of such shares is not known or included in the foregoing number. The following table presents quarterly market and dividend information for Territorial Bancorp Inc.'s common stock for the two years ended December 31, 2013. The following information with respect to high and low closing prices was provided by the NASDAQ Global Select Market.

	High	Low	Dividends Declared Per Share
<u>Year Ended December 31, 2013</u>			
Quarter ended December 31, 2013	\$ 23.89	\$ 21.80	\$ 0.24
Quarter ended September 30, 2013	\$ 23.54	\$ 21.28	\$ 0.13
Quarter ended June 30, 2013	\$ 24.33	\$ 22.61	\$ 0.13
Quarter ended March 31, 2013	\$ 24.10	\$ 22.50	\$ 0.12
<u>Year Ended December 31, 2012</u>			
Quarter ended December 31, 2012	\$ 23.39	\$ 22.00	\$ 0.22
Quarter ended September 30, 2012	\$ 24.32	\$ 22.54	\$ 0.11
Quarter ended June 30, 2012	\$ 23.14	\$ 20.87	\$ 0.11
Quarter ended March 31, 2012	\$ 21.98	\$ 19.91	\$ 0.10

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

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

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

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

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

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs (1)
December 1, 2013 through December 31, 2013	129,006	23.45	129,006	170,994

(1) On December 2, 2013, our Board of Directors authorized the repurchase of up to 300,000 shares of our common stock. In accordance with this authorization, we had repurchased 129,006 shares of our common stock as of December 31, 2013. This repurchase authorization expires on November 19, 2014. We have entered into a 10b5-1 plan with respect to our stock repurchase plan.

(f) **Stock Performance Graph.** Set forth below is a stock performance graph comparing (a) the cumulative total return on our shares of common stock between July 13, 2009 and December 31, 2013, (b) the cumulative total return on stocks included in the Total Return Index for the NASDAQ Stock Market (US) over such period, and (c) the cumulative total return on stocks included in the NASDAQ Bank Index over such period. Cumulative return assumes the reinvestment of dividends, and is expressed in dollars based on an assumed investment of \$100.

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

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

	2013	2012	Years Ended December 31, 2011		2010	2009
			(In thousands)			
Selected Financial Condition Data:						
Total assets	\$ 1,616,904	\$ 1,574,627	\$ 1,537,571	\$ 1,443,412	\$ 1,389,612	
Cash and cash equivalents	75,365	182,818	131,937	194,435	135,953	
Investment securities held to maturity	613,436	554,673	653,871	530,555	598,394	
Loans receivable, net	856,542	774,876	688,095	641,790	597,700	
Bank-owned life insurance	40,243	31,177	30,234	29,266	28,249	
Federal Home Loan Bank of Seattle stock, at cost	11,689	12,128	12,348	12,348	12,348	
Deposits	1,288,709	1,237,847	1,166,116	1,076,470	1,014,668	
Federal Home Loan Bank of Seattle advances	15,000	20,000	20,000	10,000		
Securities sold under agreements to repurchase	72,000	70,000	108,300	105,200	130,200	
Stockholders equity	212,140	218,972	213,961	227,359	219,671	

	2013	2012	Years Ended December 31, 2011		2010	2009
			(In thousands)			
Selected Operating Data:						
Interest and dividend income	\$ 56,175	\$ 60,149	\$ 62,733	\$ 61,115	\$ 61,525	
Interest expense	6,282	9,229	11,285	14,828	19,984	
Net interest income	49,893	50,920	51,448	46,287	41,541	
Provision for loan losses	39	415	418	345	1,198	
Net interest and dividend income after provision for loan losses	49,854	50,505	51,030	45,942	40,343	
Noninterest income	8,716	7,068	5,111	2,128	2,505	
Noninterest expense	35,077	34,438	34,654	31,530	29,545	
Income before income taxes	23,493	23,135	21,487	16,540	13,303	
Income taxes	8,846	8,297	8,698	5,512	4,639	
Net income	\$ 14,647	\$ 14,838	\$ 12,789	\$ 11,028	\$ 8,664	

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	At or For the Years Ended December 31,				
	2013	2012	2011	2010	2009
Selected Financial Ratios and Other Data:					
Performance Ratios:					
Return on average assets (ratio of net income to average total assets)	0.93%	0.95%	0.85%	0.77%	0.66%
Return on average equity (ratio of net income to average equity)	6.71%	6.78%	5.72%	4.91%	5.50%
Interest rate spread (1)	3.22%	3.25%	3.41%	3.14%	3.04%
Net interest margin (2)	3.28%	3.36%	3.55%	3.35%	3.26%
Efficiency ratio (3)	59.85%	59.39%	61.27%	65.12%	67.08%
Noninterest expense to average total assets	2.22%	2.20%	2.31%	2.20%	2.24%
Average interest-earning assets to average interest-bearing liabilities	117.07%	117.38%	118.21%	119.19%	114.30%
Average equity to average total assets	13.82%	13.97%	14.91%	15.69%	11.93%
Basic earnings per share (4)	\$ 1.51	\$ 1.47	\$ 1.19	\$ 0.97	\$ 0.77
Diluted earnings per share (4)	\$ 1.49	\$ 1.45	\$ 1.17	\$ 0.97	\$ 0.77
Dividend payout ratio	41.61%	37.24%	29.06%	24.74%	N/A
Asset Quality Ratios:					
Nonperforming assets to total assets	0.37%	0.28%	0.22%	0.06%	0.05%
Nonperforming loans to total loans	0.69%	0.56%	0.42%	0.12%	0.09%
Allowance for loan losses to nonperforming loans	24.77%	37.95%	52.65%	184.16%	323.27%
Allowance for loan losses to total loans	0.17%	0.22%	0.22%	0.23%	0.28%
Capital Ratios (bank-level only):					
Total capital (to risk-weighted assets)	31.99%	36.87%	38.76%	43.06%	37.18%
Tier I capital (to risk-weighted assets)	31.75%	36.57%	38.47%	42.75%	36.85%
Tier I capital (to total assets)	12.35%	13.13%	13.07%	14.02%	13.67%
Other Data:					
Number of full-service offices	28	27	27	26	25
Full-time equivalent employees	274	271	258	252	256

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

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

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

(4) The number of shares for the year ended 2009 are calculated from the effective date of July 10, 2009 to the period end.

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

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

Overview

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

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We have continued our focus on originating one- to four-family residential real estate loans. Our emphasis on conservative loan underwriting has resulted in low levels of nonperforming assets at a time when many financial institutions are experiencing significant asset quality issues. Our nonperforming assets totaled \$6.0 million or 0.37% of total assets at December 31, 2013, compared to \$4.4 million, or 0.28% of total assets at December 31, 2012, and \$3.3 million, or 0.22% of total assets at December 31, 2011. As of December 31, 2013, nonperforming assets consisted of 19 mortgage loans for \$6.0 million. Our nonperforming loans and loss experience has enabled us to maintain a relatively low allowance for loan losses in relation to other peer institutions and correspondingly resulted in low levels of provisions for loan losses. Our provisions for loan losses were \$39,000, \$415,000 and \$418,000 for the years ended December 31, 2013, 2012 and 2011, respectively.

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

Our operations in recent years have been affected by our efforts to manage our interest rate risk position. In 2013, we sold \$82.2 million of fixed-rate mortgage loans, obtained \$30.0 million of long-term, fixed-rate borrowings and purchased \$5.1 million of shorter-duration mortgage-backed securities. In 2012, we sold \$107.9 million of fixed-rate mortgage loans and purchased \$8.2 million of shorter-duration mortgage-backed securities. In 2011, we sold \$61.2 million of fixed-rate mortgage loans and obtained \$57.0 million of long-term, fixed-rate borrowings. See Management of Market Risk for a discussion of the actions we took in 2011, 2012 and 2013 in managing interest rate risk.

Territorial Savings Bank's investments in mortgage-backed securities and collateralized mortgage obligations have been issued by Freddie Mac, Fannie Mae or Ginnie Mae, U.S. government-sponsored enterprises. These agencies guarantee the payment of principal and interest on the Bank's mortgage-backed securities. We do not own any preferred stock issued by Fannie Mae or Freddie Mac. As of December 31, 2013, our borrowing capacity at the Federal Home Loan Bank of Seattle was \$375.3 million compared to \$370.6 million at December 31, 2012.

Critical Accounting Policies

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

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

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

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

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

We had previously considered our investment in PreTSL XXIV to be other-than-temporarily impaired. PreTSL XXIV has a book value of \$0. Our investment in PreTSL XXIII was determined to be other-than-temporarily impaired and we recorded an impairment charge of \$2.4 million in the year ended December 31, 2010. PreTSL XXIII has a book value of \$537,000 at December 31, 2013. The difference between the book value of \$537,000 and the remaining unamortized cost basis of \$1.1 million is reported as other comprehensive loss and is related to noncredit factors such as an inactive trust preferred securities market.

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

We evaluated our \$11.7 million investment in FHLB stock for other-than-temporary impairment as of December 31, 2013. Considering the long-term nature of this investment, the liquidity position of the FHLB of Seattle, the actions taken by the FHLB of Seattle to meet its regulatory capital requirement, and our intent not to sell this investment for a period of time sufficient to recover the par value, our FHLB stock was not considered other-than-temporarily impaired. As of December 31, 2013, the FHLB of Seattle has met all of its regulatory capital requirements. Moody's Investor Services and Standard and Poor's have given the FHLB of Seattle long-term credit ratings of Aaa and AA, respectively. Even though we did not recognize an other-than-temporary impairment loss on our investment in FHLB stock in 2013, continued deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

Deferred Tax Assets. Deferred tax assets and liabilities are recognized for the estimated future tax effects attributable to temporary differences and carryforwards. A valuation allowance may be required if, based on the weight of available evidence, it is more likely than not that some portion or all of

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the deferred tax assets will not be realized. In determining whether a valuation allowance is necessary, we consider the level of taxable income in prior years, to the extent that carrybacks are permitted under current tax laws, as well as estimates of future taxable income and tax planning strategies that could be implemented to accelerate taxable income if necessary. If our estimates of future taxable income were materially overstated or if our assumptions regarding the tax consequences of tax planning strategies were inaccurate, some or all of our deferred tax assets may not be realized, which would result in a charge to earnings.

Defined Benefit Retirement Plan. Defined benefit plan obligations and related assets of our defined benefit retirement plan are presented in Note 16 to the Consolidated Financial Statements. Effective December 31, 2008, the defined benefit retirement plan was frozen and all plan benefits were fixed as of that date. Plan assets, which consist primarily of marketable equity and debt securities, are typically valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries through the use of a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate and the expected long-term rate of return on plan assets. In determining the discount rate, we utilize a yield that reflects the top 50% of the universe of bonds, ranked in the order of the highest yield. These bonds provide cash flows that match the timing of expected benefit payments. Asset returns are based upon the anticipated average rate of earnings expected on the invested funds of the plans.

At December 31, 2013, we used weighted-average discount rates of 4.20% and 4.90% for calculating annual pension expense and projected plan liabilities, respectively, and an expected long-term rate of return on plan assets of 7.75% for calculating annual pension expense. At December 31, 2012, we used a weighted-average discount rate of 4.90% and 4.20% for calculating annual pension expense and projected plan liabilities, respectively, and an expected long-term rate of return on plan assets of 7.75% for calculating annual pension expense. For both the discount rate and the asset return rate, a range of estimates could reasonably have been used, which would affect the amount of pension expense and pension liability recorded.

A decrease in the discount rate or an increase in the asset return rate would reduce pension expense in 2013, while an increase in the discount rate or a decrease in the asset return rate would have the opposite effect. A 25 basis point decrease in the discount rate assumptions would decrease 2013 pension expense by \$2,000 and increase year-end 2013 pension liability by \$498,000, while a 25 basis point decrease in the asset return rate would increase 2013 pension expense by \$28,000.

Balance Sheet Analysis

Assets. At December 31, 2013, our assets were \$1.617 billion, an increase of \$42.3 million, or 2.7%, from \$1.575 billion at December 31, 2012. The increase was caused by an \$81.7 million increase in loans receivable due to an increase in loan production, a \$58.8 million increase in investment securities, which occurred as purchases exceeded repayments and sales and a \$9.1 million increase in bank owned life insurance. This was partially offset by a \$107.5 million decrease in cash and cash equivalents.

Cash and Cash Equivalents. At December 31, 2013, we had \$75.4 million of cash and cash equivalents compared to \$182.8 million at December 31, 2012. During 2013, cash and cash equivalents decreased by \$107.5 million due to an \$81.7 million increase in loans receivable, a \$58.8 million increase in investment securities, the repurchase of \$19.6 million of common stock and the payment of \$6.2 million of common stock dividends. This was partially offset by a \$50.9 million increase in deposits and net income of \$14.6 million.

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

	2013		2012		At December 31, 2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
(Dollars in thousands)										
Real estate loans:										
First mortgage:										
One- to four-family residential	\$ 823,273	95.41%	\$ 741,334	94.84%	\$ 654,412	94.13%	\$ 604,456	93.16%	\$ 555,473	91.87%
Multi-family residential	4,877	0.57	6,888	0.88	6,956	1.00	5,408	0.83	3,807	0.63
Construction, commercial and other	13,554	1.57	13,819	1.77	11,140	1.60	13,300	2.05	16,672	2.76
Home equity loans and lines of credit	16,524	1.91	15,202	1.94	17,253	2.48	20,064	3.09	21,789	3.60
Other loans	4,649	0.54	4,481	0.57	5,488	0.79	5,635	0.87	6,895	1.14
Total loans	862,877	100.00%	781,724	100.00%	695,249	100.00%	648,863	100.00%	604,636	100.00%
Other items:										
Unearned fees and discounts, net	(4,849)		(5,176)		(5,613)		(5,585)		(5,255)	
Allowance for loan losses	(1,486)		(1,672)		(1,541)		(1,488)		(1,681)	
Loans receivable, net	\$ 856,542		\$ 774,876		\$ 688,095		\$ 641,790		\$ 597,700	

Loan Portfolio Maturities and Yields. The following table summarizes the scheduled maturities of our loan portfolio at December 31, 2013. Demand loans, loans having no stated repayment schedule or maturity, and overdraft loans are reported as being due in one year or less.

Due During the Years Ending December 31,	One- to four-family residential real estate		Multi-family residential real estate		Construction, commercial and other real estate		Home equity loans and lines of credit		Other loans		Total	
	Amount	Average Rate	Amount	Average Rate	Amount	Average Rate	Amount	Average Rate	Amount	Average Rate	Amount	Average Rate
(Dollars in thousands)												
2014	\$ 1	7.38%	\$ 432	7.00%	\$ 875	5.00%	\$ 707	6.95%	\$ 2,015	6.11%		
2015 to 2018	2,279	4.99			1,005	6.63	1,488	5.30	1,154	5.51	5,926	5.45
2019 and beyond	820,993	4.29	4,445	5.52	11,674	5.12	15,036	4.88	2,788	5.59	854,936	4.32
Total	\$ 823,273	4.29%	\$ 4,877	5.65%	\$ 13,554	5.22%	\$ 16,524	4.91%	\$ 4,649	5.78%	\$ 862,877	4.33%

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The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at December 31, 2013 that are contractually due after December 31, 2014.

	Fixed	Due After December 31, 2014 Adjustable (In thousands)		Total
Real estate loans:				
First mortgage:				
One- to four-family residential	\$ 818,150	\$ 5,122	\$	823,272
Multi-family residential	3,948	497		4,445
Construction, commercial and other	8,996	3,683		12,679
Home equity loans and lines of credit	5,524	11,000		16,524
Other loans	3,348	594		3,942
Total loans	\$ 839,966	\$ 20,896	\$	860,862

Securities. At December 31, 2013, our securities portfolio totaled \$613.4 million, or 37.9% of assets. At that date, our securities held to maturity consisted of securities with the following amortized costs: \$586.7 million of mortgage-backed securities, \$26.2 million of collateralized mortgage obligations and \$537,000 of trust preferred securities. All of the mortgage-backed securities and collateralized mortgage obligations were issued by Fannie Mae, Freddie Mac or Ginnie Mae. At December 31, 2013, none of the underlying collateral consisted of subprime or Alt-A loans (traditionally defined as nonconforming loans having less than full documentation). At December 31, 2013, we held no common or preferred stock of Fannie Mae or Freddie Mac.

During the year ended December 31, 2013, our securities portfolio increased by \$58.8 million, or 10.6%, primarily due to purchases exceeding repayments and sales.

The following table sets forth the amortized cost and estimated fair value of our securities portfolio (excluding Federal Home Loan Bank of Seattle common stock) at the dates indicated.

	2013		At December 31, 2012		2011	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)					
Held to Maturity:						
U.S. government sponsored mortgage-backed securities:						
Fannie Mae	\$ 200,058	\$ 191,717	\$ 124,106	\$ 127,929	\$ 69,254	\$ 73,043
Freddie Mac	331,753	326,707	348,569	371,141	462,546	486,895
Collateralized mortgage obligations (1)	26,238	25,853	44,302	44,698	74,548	76,408
Ginnie Mae	54,850	53,193	37,275	39,936	47,491	50,714
Total U.S. government sponsored mortgage-backed securities	612,899	597,470	554,252	583,704	653,839	687,060

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Trust preferred securities	537	537	421	421	32	259
Total	\$ 613,436	\$ 598,007	\$ 554,673	\$ 584,125	\$ 653,871	\$ 687,319

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

Any unrealized loss on individual mortgage-backed securities as of December 31, 2013, 2012 and 2011 was caused by increases in current market interest rates. All of our mortgage-backed securities are guaranteed by U.S. government-sponsored enterprises. Since the decline in market value has been attributable to changes in interest rates and not credit quality, and we have had, and continue to have, the

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intent not to sell these investments, and it is not more likely than not that we will be required to sell such investments prior to the recovery of the amortized cost basis, we have not considered these investments to be other-than-temporarily impaired as of December 31, 2013, 2012 or 2011.

At December 31, 2013, we owned trust preferred securities with a carrying value of \$537,000. 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 three transactions have occurred over the past 24 months in the same tranche of securities that we own. We used a discounted cash flow model to determine whether these securities are other-than-temporarily impaired. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates, estimated deferral and default rates on collateral, and estimated cash flows. We used a discount rate equal to three-month LIBOR plus 20.00% and provided a fair value estimate of \$15.15 per \$100 of par value for PreTSL XXIII.

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

At December 31, 2013, we had no investments in a single company (other than U.S. government sponsored enterprises) or entity that had an aggregate book value in excess of 10% of our consolidated stockholders' equity.

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

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

During the year ended December 31, 2013, our deposits grew by \$50.9 million, or 4.1%. The increase was caused by our strategy of promoting higher-than-market rates for our passbook and statement savings accounts. Savings accounts grew by \$30.1 million, or 3.4%, because of the higher interest rates offered. We also believe that the ability to get immediate access to their funds without incurring an early withdrawal penalty appeals to customers.

At December 31, 2013, we had a total of \$210.0 million in certificates of deposit, of which \$152.8 million had remaining maturities of one year or less. Based on historical experience and our current pricing strategy, we believe we will retain a significant portion of these accounts upon maturity.

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

	For the Years Ended December 31,					
	2013			2012		
Average Balance	Percent	Weighted Average Rate	Average Balance	Percent	Weighted Average Rate	
(Dollars in thousands)						
Deposit type:						
Noninterest-bearing	\$ 31,863	2.6%	%	\$ 29,049	2.4%	%
Savings accounts	889,986	71.2	0.34%	849,945	70.3	0.51%
Certificates of deposit	197,604	15.8	0.62%	214,722	17.8	0.75%
Money market	761	0.1	0.26%	536		0.19%
Checking and Super NOW	129,160	10.3	0.02%	114,913	9.5	0.03%
Total deposits	\$ 1,249,374	100.0%	0.34%	\$ 1,209,165	100.0%	0.49%

For the Year Ended December 31, 2011		
Average Balance	Percent	Weighted Average Rate
(Dollars in thousands)		

Deposit type:

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Noninterest-bearing	\$	22,566	2.0%	%
Savings accounts		771,194	69.1	0.61%
Certificates of deposit		215,609	19.3	0.93%
Money market		540		0.37%
Checking and Super NOW		106,218	9.6	0.05%
Total deposits	\$	1,116,127	100.0%	0.61%

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As of December 31, 2013, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to \$100,000 was \$157.5 million. The following table sets forth the maturity of those certificates as of December 31, 2013.

At December 31, 2013 (In thousands)	
Three months or less	\$ 35,465
Over three months through six months	28,212
Over six months through one year	57,422
Over one year to three years	33,159
Over three years	3,231
Total	\$ 157,489

Borrowings. Our borrowings consist of advances from the Federal Home Loan Bank of Seattle and funds borrowed under securities sold under agreements to repurchase. At December 31, 2013, our securities sold under agreements to repurchase totaled \$72.0 million, or 5.1% of total liabilities and our Federal Home Loan Bank advances totaled \$15.0 million, or 1.1% of total liabilities. At December 31, 2013, we had the capability to borrow up to \$375.3 million in the form of additional advances from the Federal Home Loan Bank.

During the year ended December 31, 2013, our borrowings decreased by \$3.0 million, or 3.3%. The decrease occurred when we had a net pay off of \$5.0 million of Federal Home Loan Bank advances that was partially offset by a \$2.0 million net increase in securities sold under agreements to repurchase. We have not required any other borrowings to fund our operations. Instead, we have primarily funded our operations with the net proceeds from our stock offering, additional deposits, proceeds from loan and security sales and principal repayments on loans and mortgage-backed securities.

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

	At or For the Years Ended December 31,		
	2013	2012	2011
	(Dollars in thousands)		
Balance at end of year	\$ 15,000	\$ 20,000	\$ 20,000
Average balance during year	\$ 15,836	\$ 20,000	\$ 19,178
Maximum outstanding at any month end	\$ 20,000	\$ 20,000	\$ 20,000
Weighted average interest rate at end of year	1.77%	2.09%	2.09%
Average interest rate during year	1.91%	2.09%	2.09%

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

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	At or For the Years Ended December 31,		
	2013	2012	2011
	(Dollars in thousands)		
Balance at end of year	\$ 72,000	\$ 70,000	\$ 108,300
Average balance during year	\$ 64,111	\$ 89,849	\$ 114,022
Maximum outstanding at any month end	\$ 72,000	\$ 108,300	\$ 122,200
Weighted average interest rate at end of year	1.88%	2.86%	3.35%
Average interest rate during year	2.63%	3.20%	3.61%

Stockholders Equity. At December 31, 2013, our stockholders equity was \$212.1 million, a decrease of \$6.8 million, or 3.1%, from \$219.0 million at December 31, 2012. The decrease in stockholders equity primarily resulted from the repurchase of 868,203 shares of our common stock for \$19.6 million and the declaration of \$6.2 million of dividends during the year ended December 31, 2013. This was partially offset by net income of \$14.6 million, a \$2.7 million increase in paid-in-capital related to share-based compensation awards and a \$1.1 million increase due to the allocation of ESOP shares.

Table of Contents**Average Balances and Yields**

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

	For the Year Ended December 31, 2013		
	Average Outstanding Balance	Interest (Dollars in thousands)	Yield/ Rate
Interest-earning assets:			
Loans:			
Real estate loans:			
First mortgage:			
One- to four-family residential (1)	\$ 780,556	\$ 34,905	4.47%
Multi-family residential	5,706	328	5.75
Construction, commercial and other	13,397	661	4.93
Home equity loans and lines of credit	15,237	805	5.28
Other loans	4,728	283	5.99
Total loans	819,624	36,982	4.51
Investment securities:			
U.S. government sponsored mortgage-backed securities (1)	580,600	18,941	3.26
Trust preferred securities	494		
Total securities	581,094	18,941	3.26
Other	118,252	252	0.21
Total interest-earning assets	1,518,970	56,175	3.70
Non-interest-earning assets	60,356		
Total assets	\$ 1,579,326		
Interest-bearing liabilities:			
Savings accounts	\$ 889,986	3,035	0.34%
Certificates of deposit	197,604	1,231	0.62
Money market accounts	761	2	0.26
Checking and Super NOW accounts	129,160	28	0.02
Total interest-bearing deposits	1,217,511	4,296	0.35
Federal Home Loan Bank advances	15,836	302	1.91
Securities sold under agreements to repurchase	64,111	1,684	2.63
Total interest-bearing liabilities	1,297,458	6,282	0.48
Non-interest-bearing liabilities	63,567		
Total liabilities	1,361,025		
Stockholders equity	218,301		
Total liabilities and stockholders equity	\$ 1,579,326		
Net interest income		\$ 49,893	
Net interest rate spread (2)			3.22%
Net interest-earning assets (3)	\$ 221,512		
Net interest margin (4)			3.28%

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Interest-earning assets to interest-bearing liabilities

117.07%

(footnotes on following page)

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	For the Years Ended December 31,					
	2012			2011		
	Average Outstanding Balance	Interest	Yield/ Rate (Dollars in thousands)	Average Outstanding Balance	Interest	Yield/ Rate
Interest-earning assets:						
Loans:						
Real estate loans:						
First mortgage:						
One- to four-family residential (1)	\$ 694,146	\$ 34,251	4.93%	\$ 620,971	\$ 32,872	5.29%
Multi-family residential	6,784	416	6.13	6,183	394	6.37
Construction, commercial and other	12,072	669	5.54	13,868	828	5.97
Home equity loans and lines of credit	15,850	922	5.82	18,367	1,117	6.08
Other loans	5,006	308	6.15	5,451	346	6.35
Total loans	733,858	36,566	4.98	664,840	35,557	5.35
Investment securities:						
U.S. government sponsored mortgage-backed securities (1)	616,627	23,224	3.77	635,587	26,851	4.22
Trust preferred securities	107			32		
Total securities	616,734	23,224	3.77	635,619	26,851	4.22
Other	163,569	359	0.22	149,668	325	0.22
Total interest-earning assets	1,514,161	60,149	3.97	1,450,127	62,733	4.33
Non-interest-earning assets	52,169			50,284		
Total assets	\$ 1,566,330			\$ 1,500,411		
Interest-bearing liabilities:						
Savings accounts	\$ 849,945	4,295	0.51%	\$ 771,194	4,707	0.61%
Certificates of deposit	214,722	1,604	0.75	215,609	2,013	0.93
Money market accounts	536	1	0.19	540	2	0.37
Checking and Super NOW accounts	114,913	36	0.03	106,218	48	0.05
Total interest-bearing deposits	1,180,116	5,936	0.50	1,093,561	6,770	0.62
Federal Home Loan Bank advances	20,000	418	2.09	19,178	401	2.09
Securities sold under agreements to repurchase	89,876	2,875	3.20	114,022	4,114	3.61
Total interest-bearing liabilities	1,289,992	9,229	0.72	1,226,761	11,285	0.92
Non-interest-bearing liabilities	57,591			49,980		
Total liabilities	1,347,583			1,276,741		
Stockholders equity	218,747			223,670		
Total liabilities and stockholders equity	\$ 1,566,330			\$ 1,500,411		
Net interest income		\$ 50,920			\$ 51,448	
Net interest rate spread (2)			3.25%			3.41%
Net interest-earning assets (3)	\$ 224,169			\$ 223,366		
Net interest margin (4)			3.36%			3.55%
Interest-earning assets to interest-bearing liabilities	117.38%			118.21%		

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

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

Table of Contents**Rate/Volume Analysis**

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

	Years Ended December 31, 2013 vs. 2012			Years Ended December 31, 2012 vs. 2011		
	Increase (Decrease) Due to		Total Increase (Decrease) (In thousands)	Increase (Decrease) Due to		Total Increase (Decrease)
	Volume	Rate		Volume	Rate	
Interest-earning assets:						
Loans:						
Real estate loans:						
First mortgage:						
One- to four-family residential	\$ 2,647	\$ (1,993)	\$ 654	\$ 3,253	\$ (1,874)	\$ 1,379
Multi-family residential	(63)	(25)	(88)	36	(14)	22
Construction, commercial and other	69	(77)	(8)	(102)	(57)	(159)
Home equity loans and lines of credit	(35)	(82)	(117)	(148)	(47)	(195)
Other loans	(17)	(8)	(25)	(28)	(10)	(38)
Total loans	2,601	(2,185)	416	3,011	(2,002)	1,009
U.S. government sponsored mortgage-backed securities	(1,302)	(2,981)	(4,283)	(782)	(2,845)	(3,627)
Other	(97)	(10)	(107)	30	4	34
Total interest-earning assets	1,202	(5,176)	(3,974)	2,259	(4,843)	(2,584)
Interest-bearing liabilities:						
Savings accounts	213	(1,473)	(1,260)	601	(1,013)	(412)
Certificates of deposit	(121)	(252)	(373)	(8)	(401)	(409)
Money market accounts	1		1		(1)	(1)
Checking and Super NOW accounts	5	(13)	(8)	4	(16)	(12)
Total interest-bearing deposits	98	(1,738)	(1,640)	597	(1,431)	(834)
Federal Home Loan Bank advances	(82)	(34)	(116)	17	0	17
Securities sold under agreements to repurchase	(733)	(458)	(1,191)	(807)	(432)	(1,239)
Total interest-bearing liabilities	(717)	(2,230)	(2,947)	(193)	(1,863)	(2,056)
Change in net interest income	\$ 1,919	\$ (2,946)	\$ (1,027)	\$ 2,452	\$ (2,980)	\$ (528)

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Comparison of Operating Results for the Years Ended December 31, 2013, 2012 and 2011

General. Net income decreased by \$191,000, or 1.3%, to \$14.6 million for the year ended December 31, 2013 from \$14.8 million for the year ended December 31, 2012. The decrease in net income was caused by a \$4.0 million decrease in interest and dividend income due to lower market interest rates and a lower average securities balance, a \$639,000 increase in noninterest expense and a \$549,000 increase in income taxes. This was partially offset by a \$2.9 million decrease in interest expense due to lower market interest rates, a \$1.6 million increase in noninterest income due to an increase in gains on sale of securities and a \$376,000 decrease in the provision for loan losses.

Net income increased by \$2.0 million, or 16.0%, to \$14.8 million for the year ended December 31, 2012 from \$12.8 million for the year ended December 31, 2011. The increase in net income was caused by a \$2.1 million decrease in interest expense due to lower market interest rates, a \$2.0 million increase in noninterest income due to an increase in gains on sale of loans and securities, a \$401,000 decrease in income taxes and a \$216,000 decrease in noninterest expense. This was partially offset by a \$2.6 million decrease in interest and dividend income due to lower market interest rates and a lower average securities balance.

Net Interest Income. Net interest income decreased by \$1.0 million, or 2.0%, to \$49.9 million for the year ended December 31, 2013 from \$50.9 million for the year ended December 31, 2012. Interest and dividend income decreased by \$4.0 million, or 6.6%, to \$56.2 million for the year ended December 31, 2013 from \$60.1 million for the year ended December 31, 2012. The decrease in interest and dividend income occurred primarily because of a 27 basis point decrease in the average asset yield that was partially offset by a \$4.8 million increase in the average balance. Interest expense decreased by \$2.9 million, or 31.9%, to \$6.3 million for the year ended December 31, 2013 from \$9.2 million for the year ended December 31, 2012. The decrease in interest expense is primarily due to a 24 basis point decrease in the average cost of interest-bearing liabilities that was partially offset by a \$7.5 million increase in the average balance. The interest rate spread and net interest margin were 3.22% and 3.28%, respectively, for the year ended December 31, 2013, compared to 3.25% and 3.36% for 2012. The three basis point decrease in the net interest rate spread is due to a 27 basis point decrease in the average yield on interest-earning assets that was partially offset by a 24 basis point decrease in the cost of interest-bearing liabilities. The decrease in the cost of interest-bearing liabilities resulted from lower market interest rates.

Net interest income decreased by \$528,000, or 1.0%, to \$50.9 million for the year ended December 31, 2012 from \$51.4 million for the year ended December 31, 2011. Interest and dividend income decreased by \$2.6 million, or 4.1%, to \$60.1 million for the year ended December 31, 2012 from \$62.7 million for the year ended December 31, 2011. The decrease in interest and dividend income occurred primarily because of a 36 basis point decrease in the average asset yield that was partially offset by a \$64.0 million increase in the average balance. Interest expense decreased by \$2.1 million, or 18.2%, to \$9.2 million for the year ended December 31, 2012 from \$11.3 million for the year ended December 31, 2011. The decrease in interest expense is primarily due to a 20 basis point decrease in the average cost of interest-bearing liabilities. The interest rate spread and net interest margin were 3.25% and 3.36%, respectively, for the year ended December 31, 2012, compared to 3.41% and 3.55% for 2011. The 16 basis point decrease in the net interest rate spread is due to a 36 basis point decrease in the average yield on interest-earning assets that was partially offset by a 20 basis point decrease in the cost of interest-bearing liabilities. The decrease in the cost of interest-bearing liabilities resulted from lower market interest rates.

Interest and Dividend Income. Interest and dividend income decreased by \$4.0 million, or 6.6%, to \$56.2 million for the year ended December 31, 2013 from \$60.1 million for the year ended December 31, 2012. Interest income on investment securities decreased by \$4.3 million, or 18.4%, to \$18.9 million for the year ended December 31, 2013 from \$23.2 million for the year ended December 31, 2012. The decrease in interest income on securities occurred because of a 51 basis point decrease in the average securities yield and a \$35.6 million decrease in the average securities balance. The decline in the average yield and balance occurred because a

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portion of the proceeds from repayments and sales of higher yielding mortgage-backed securities were reinvested at lower yields. Interest income on loans increased by \$416,000, or 1.1%, to \$37.0 million for the year ended December 31, 2013 from \$36.6 million for the year ended December 31, 2012. The increase in interest income on loans occurred because the average balance of loans grew by \$85.8 million, or 11.7%, as new loan originations exceeded loan repayments and loan sales. This increase in interest income was partially offset by a 47 basis point decline in the average loan yield to 4.51% for the year ended December 31, 2013 compared to 4.98% for the year ended December 31, 2012. The decline in the average yield on loans occurred because of repayments on higher-yielding loans and additions of new loans with lower yields to the loan portfolio.

Interest and dividend income decreased by \$2.6 million, or 4.1%, to \$60.1 million for the year ended December 31, 2012 from \$62.7 million for the year ended December 31, 2011. Interest income on investment securities decreased by \$3.6 million, or 13.5%, to \$23.2 million for the year ended December 31, 2012 from \$26.9 million for the year ended December 31, 2011. The decrease in interest income on securities occurred because of a 45 basis point decrease in the average securities yield and an \$18.9 million decrease in the average securities balance. The decline in the average yield and balance occurred because of an increase in repayments on higher yielding mortgage-backed securities. A portion of these repayments were reinvested in securities with lower yields. Interest income on loans increased by \$1.0 million, or 2.8%, to \$36.6 million for the year ended December 31, 2012 from \$35.6 million for the year ended December 31, 2011. The increase in interest income on loans occurred because the average balance of loans grew by \$69.0 million, or 10.4%, as new loan originations exceeded loan repayments and loan sales. This increase in interest income was partially offset by a 37 basis point decline in the average loan yield to 4.98% for the year ended December 31, 2012 compared to 5.35% for the year ended December 31, 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 \$2.9 million, or 31.9%, to \$6.3 million for the year ended December 31, 2013 from \$9.2 million for the year ended December 31, 2012. Interest expense on deposits decreased by \$1.6 million, or 27.6%, to \$4.3 million for the year ended December 31, 2013 from \$5.9 million for the year ended December 31, 2012. During the year ended December 31, 2013, interest expense on savings accounts and certificates of deposit declined by \$1.3 million and \$373,000, respectively, due to a decrease in the average interest rates of 17 and 13 basis points, respectively. 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 a \$37.4 million, or 3.2%, increase in the average balance of deposit accounts. Interest expense on securities sold under agreements to repurchase decreased by \$1.2 million, or 41.4%, during the year ended December 31, 2013. This decrease was caused by a \$25.8 million, or 28.7%, decrease in the average outstanding balance and a 57 basis point decrease in the average interest rate to 2.6% for the year ended December 31, 2013 compared to 3.20% for the year ended December 31, 2012. The decrease in the average outstanding balance was due to the repayment of \$23.0 million of matured borrowings during the year ended December 31, 2013.

Interest expense decreased by \$2.1 million, or 18.2%, to \$9.2 million for the year ended December 31, 2012 from \$11.3 million for the year ended December 31, 2011. Interest expense on securities sold under agreements to repurchase decreased by \$1.2 million, or 30.1%, during the year ended December 31, 2012. This decrease was caused by a \$24.1 million, or 21.2%, decrease in the average outstanding balance and a 41 basis point decrease in the average interest rate to 3.20% for the year ended December 31, 2012 compared to 3.61% for the year ended December 31, 2011. The decrease in the average outstanding balance was due to the repayment of \$13.3 million of maturing borrowings and prepayment of \$25.0 million of borrowings during the year ended December 31, 2012. Interest expense on deposits decreased by \$834,000, or 12.3%, to \$5.9 million for the year ended December 31, 2012 from \$6.8 million for the year ended December 31, 2011. During the year ended December 31, 2012, interest expense on certificates of deposit and savings accounts declined by \$409,000 and

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\$412,000, respectively, due to a decrease in the average interest rates of 18 and 10 basis points, respectively. 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 \$86.6 million, or 7.9%, increase in the average balance of deposit accounts.

Provision for Loan Losses. Based on our analysis of the factors described in Allowance for Loan Losses, we recorded provisions for loan losses of \$39,000, \$415,000 and \$418,000 for the years ended December 31, 2013, 2012 and 2011, respectively. The provisions for loan losses reflected net charge-offs of \$225,000, \$284,000 and \$365,000 for the years ended December 31, 2013, 2012 and 2011, respectively. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.17%, 0.22% and 0.22% at December 31, 2013, 2012 and 2011, respectively. Nonaccrual loans totaled \$6.0 million, \$4.4 million and \$2.9 million at December 31, 2013, 2012 and 2011, respectively. To the best of our knowledge, at December 31, 2013, 2012 and 2011, we had provided for all losses that are both probable and reasonable to estimate at those respective dates.

Noninterest Income. The following table summarizes changes in noninterest income for the years ended December 31, 2013, 2012 and 2011.

	Years Ended December 31,			Change 2013/2012		Change 2012/2011	
	2013	2012	2011	\$ Change	% Change	\$ Change	% Change
	(Dollars in thousands)						
Service fees on loan and deposit accounts	\$ 2,232	\$ 2,044	\$ 2,284	\$ 188	9.2%	\$ (240)	(10.5)%
Income on bank-owned life insurance	1,066	942	968	124	13.2%	(26)	(2.7)%
Gain on sale of investment securities	3,450	1,234	451	2,216	179.6%	783	173.6%
Gain on sale of loans	1,541	2,411	711	(870)	(36.1)%	1,700	239.1%
Other	427	437	697	(10)	(2.3)%	(260)	(37.3)%
Total	\$ 8,716	\$ 7,068	\$ 5,111	\$ 1,648	23.3%	\$ 1,957	38.3%

Noninterest income increased by \$1.6 million for the year ended December 31, 2013 compared to the year ended December 31, 2012. During the years ended December 31, 2013 and 2012, we sold \$47.7 million and \$16.0 million, respectively, of held-to-maturity investment securities and recognized gains of \$3.5 million and \$1.2 million, respectively. The sale of these securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio. During the years ended December 31, 2013 and 2012, we also sold \$82.2 million and \$107.9 million, respectively, of mortgage loans held for sale and recognized gains of \$1.5 million and \$2.4 million, respectively.

Noninterest income increased by \$2.0 million for the year ended December 31, 2012 compared to the year ended December 31, 2011. During the years ended December 31, 2012 and 2011, we sold \$107.9 million and \$61.2 million, respectively, of mortgage loans held for sale and recognized gains of \$2.4 million and \$711,000, respectively. During the years ended December 31, 2012 and 2011, we also sold \$16.0 million and \$3.5 million, respectively, of held-to-maturity investment securities and recognized gains of \$1.2 million and \$261,000, respectively. The sale of these securities, for which the Company had already received a substantial portion of the outstanding principal (at least 85%), is in accordance with the Investment topic of the FASB ASC and will not affect the historical cost basis used to account for the remaining securities in the held-to-maturity portfolio.

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Noninterest Expense. The following table summarizes changes in noninterest expense for the years ended December 31, 2013, 2012 and 2011.

	Years Ended December 31,			Change 2013/2012		Change 2012/2011	
	2013	2012	2011	\$ Change	% Change	\$ Change	% Change
(Dollars in thousands)							
Salaries and employee benefits	\$ 21,015	\$ 20,609	\$ 21,621	\$ 406	2.0%	\$ (1,012)	(4.7)%
Occupancy	5,365	5,246	4,988	119	2.3%	258	5.2%
Equipment	3,524	3,269	3,191	255	7.8%	78	2.4%
Loss on extinguishment of debt		321		(321)	(100.0)%	321	n/a
Federal deposit insurance premiums	770	767	865	3	0.4%	(98)	(11.3)%
Other general and administrative expenses	4,403	4,226	3,989	177	4.2%	237	5.9%
Total	\$ 35,077	\$ 34,438	\$ 34,654	\$ 639	1.9%	\$ (216)	(0.6)%

Noninterest expense increased by \$639,000 to \$35.1 million for the year ended December 31, 2013 from \$34.4 million for the year ended December 31, 2012. Salaries and employee benefits increased by \$406,000 during the year ended December 31, 2013 primarily due to a bank-wide budgeted salary increase of approximately 2.0%, which was effective July 1, 2013, and higher health insurance costs. During the year ended December 31, 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 is expected to reduce interest expense in future periods on securities sold under agreements to repurchase.

Noninterest expense decreased by \$216,000 to \$34.4 million for the year ended December 31, 2012 from \$34.7 million for the year ended December 31, 2011. Salaries and employee benefits decreased by \$1.0 million during the year ended December 31, 2012 primarily because the Company recognized \$696,000 of share-based compensation expenses in the year ended December 31, 2011 when a director passed away that resulted in the immediate vesting of restricted stock and stock options. In addition, the Company recognized a \$762,000 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. This was partially offset by a bank-wide budgeted salary increase of approximately 2.0%, which was effective July 1, 2012, and higher cash bonuses. During the year ended December 31, 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 is expected to reduce interest expense in future periods on securities sold under agreements to repurchase.

Income Tax Expense. Income taxes were \$8.8 million for 2013, reflecting an effective tax rate of 37.7%, \$8.3 million for 2012, reflecting an effective tax rate of 35.9%, and \$8.7 million for 2011, reflecting an effective tax rate of 40.5%. The effective tax rate in 2013 was higher than the effective tax rate in 2012 primarily due to a decrease in permanent tax benefits related to our share-based compensation plans, which occurred because of a decrease in our share price, and a one-time reduction in deferred taxes related to prepaid expenses that occurred in 2012. These items were partially offset by an increase in earnings on bank-owned life insurance, which is tax exempt. The effective tax rate in 2012 was lower than the effective tax rate in 2011 primarily due to an increase in permanent tax benefits related to our share-based compensation plans and a one-time reduction in deferred taxes related to prepaid expenses.

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Nonperforming and Problem Assets

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

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

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

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

	2013	2012	At December 31, 2011	2010	2009
	(Dollars in thousands)				
Nonaccrual loans:					
Real estate loans:					
First mortgage:					
One- to four-family residential	\$ 5,840	\$ 4,246	\$ 2,582	\$ 801	\$ 517
Construction, commercial and other			184	2	
Home equity loans and lines of credit	160	160	158		
Other loans			3	5	3
Total nonaccrual loans	6,000	4,406	2,927	808	520
Real estate owned:					
Real estate loans:					
First mortgage:					