



Territorial Bancorp Inc.

2019 ANNUAL REPORT





CHAIRMAN AND CEO'S MESSAGE

Fellow Shareholders:

On behalf of our Board of Directors and employees, I would like to thank our shareholders and customers for your support over the last 10 years. Since becoming a public company in July, 2009, we have strived to provide our shareholders with a solid return on their investment. In 2019, our net income, earnings per share, dividends paid to shareholders, loans receivable, deposits and total assets rose to new highs since we became a public company in 2009.

2019 Highlights and Financial Performance

In 2019, our net income was \$22.00 million, an increase of \$2.78 million or 14.49% over 2018's net income of \$19.21 million. Fully diluted earnings per share rose to \$2.34 per share of common stock in 2019, increasing by 15.27% compared to 2018's fully diluted earnings per share.

Some highlights from 2019 are:

- Interest income on loans grew to \$63.14 million, an increase of \$2.86 million from 2018.
- Return on average assets rose to 1.06%, compared to 0.95% in 2018, an increase of 11 basis points or 11.58%.
- We did not have any delinquent mortgage loans that were 90 days past due and not accruing at December 31, 2019 compared to \$879,000 at December 31, 2018. Our ratio of nonperforming assets to total assets declined to 0.04% in 2019 compared to 0.11% in 2018.
- In 2019, we completed our eighth share repurchase program and implemented our ninth repurchase program. Through December

31, 2019, we have repurchased 3.50 million shares, or 28.62% of the shares issued in our initial public offering.

- In 2019 we paid cash dividends of \$1.49 per share, including special dividends in July and December, an increase of \$0.35 over 2018.
- Regulatory capital ratios for Territorial Bancorp Inc. and Territorial Savings Bank are in excess of Federal “well-capitalized” standards.

Hawaii’s Economy

The visitor industry remained the mainstay of Hawaii’s economic engine and set another record in 2019 with visitor arrivals increasing by 5.4% over 2018 to 10.42 million. Visitor spending was \$17.75 billion in 2019, an increase of 1.4% over 2018. We expect that the recent coronavirus pandemic will reduce the number of visitors to Hawaii which will negatively affect our economy.

The military continues to be the second largest segment of Hawaii’s economy. The Chamber of Commerce of Hawaii estimates military and federal spending total about \$8.8 billion annually. Hawaii will continue to play a major role in military activity, as it is centrally located in the Pacific Ocean and provides a strategic vantage point to protect against military threats to our nation.

Construction in Hawaii continues to be an important part of Hawaii’s economy. Along the Kapiolani corridor, condominium projects have broken ground and will be in the construction phase for the next few years. Also, the Koa Ridge development in Central Oahu has begun the process of applying for building permits that would result in the construction of thousands of homes. The Honolulu Rail project is proceeding and the first phase of the project is expected to start operating by the end of 2020 with the completion of the final phase to Ala Moana Shopping Center by the end of 2025.

Hawaii's unemployment rate for December 2019 was 2.6% compared to the national unemployment rate of 3.5%. Our visitor, defense and construction industries have kept our local economy strong and allowed us to keep the State's unemployment rate lower than the national rate.

2019 was a very good year for Territorial Bancorp. However, there are significant headwinds facing us as we begin 2020. The emergence of the coronavirus pandemic will have a significant economic impact not only in Hawaii but the rest of the world. The final cost is not yet determinable, but we anticipate it will be very high. With our strong balance sheet and operational efficiencies we feel very confident that we will work through this period of uncertainty. Our Board of Directors and employees would like to express our appreciation to all our shareholders and customers for your ongoing support and understanding as we face this new challenge.

A handwritten signature in black ink, appearing to read "Allan S. Kitagawa". The signature is fluid and cursive, with a prominent initial "A" and "K".

Allan S. Kitagawa
Chairman, Chief Executive Officer and President

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, 2019

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)

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:

Title of each class

Common stock

Trading symbol

TBNK

Name of each exchange on which registered

The Nasdaq Stock Market LLC

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

None

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

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer
Non-accelerated filer
Emerging growth company

Accelerated filer
Smaller reporting company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

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, 2019 (\$30.90) was \$269.9 million.

As of February 29, 2020, there were 9,686,048 shares outstanding of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2020 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

TERRITORIAL BANCORP INC.
FORM 10-K
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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements, which can be identified by the use of words such as “estimate,” “project,” “believe,” “intend,” “anticipate,” “plan,” “seek,” “expect,” “will,” “may” and words of similar meaning. These forward-looking statements include, but are not limited to:

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

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

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

- general economic conditions, internationally, nationally or in our market areas, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- adverse changes in the securities or credit markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- changes in monetary or fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board;
- our ability to enter new markets successfully and capitalize on growth opportunities;
- our ability to successfully integrate acquired entities, if any;
- changes in consumer demand, 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;
- the timing and amount of revenues that we may recognize;
- the value and marketability of collateral underlying our loan portfolios;
- our ability to retain key employees;
- cyber attacks, computer viruses and other technological risks that may breach the security of our websites or other systems to obtain unauthorized access to confidential information, destroy data or disable our systems;
- technological changes that may be more difficult or expensive than expected;
- the ability of third-party providers to perform their obligations to us;

- the ability of the U.S. Government to manage federal debt limits;
- the effects of any federal government shutdown;
- the quality and composition of our investment portfolio;
- changes in market and other conditions that would affect our ability to repurchase our common stock;
- 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. (the Company) is a Maryland corporation and owns 100% of the outstanding common stock of Territorial Savings Bank. In 2009, we completed our initial public offering of common stock in connection with the mutual-to-stock conversion of Territorial Mutual Holding Company. Since the completion of our initial public offering, we have not engaged in any significant business activity other than owning the common stock of and having savings deposits in Territorial Savings Bank, paying dividends and repurchasing shares of common stock. At December 31, 2019, we had consolidated assets of \$2.1 billion, consolidated deposits of \$1.6 billion and consolidated stockholders’ equity of \$243.9 million.

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

Territorial Savings Bank

Territorial Savings Bank is a Hawaii state-chartered savings bank headquartered in Honolulu, Hawaii. Territorial Savings Bank was organized in 1921, and reorganized into the mutual holding company structure in 2002. Territorial Savings Bank is currently the wholly-owned subsidiary of Territorial Bancorp Inc. We provide financial services to individuals, families and businesses through our 29 banking offices located throughout the State of Hawaii.

In 2014, Territorial Savings Bank converted from a federal savings bank to a Hawaii state-chartered savings bank and became a member of the Federal Reserve System.

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

Available Information

Territorial Bancorp Inc. is a public company, and files current, quarterly and annual reports with the Securities and Exchange Commission. These reports and any amendments to these reports are available for free on our website, www.territorialsavings.net as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Information on our website should not be considered a part of this Annual Report on Form 10-K. 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>).

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 29 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 10.4 million visitors came to the state in 2019, a 5.4% increase compared to 2018. The increase in visitor arrivals is primarily due to growth in the number of visitors from the continental United States. Total visitor expenditures in 2019 totaled \$17.8 billion, a 1.4% increase compared to 2018.

The unemployment rate for the State of Hawaii remained unchanged at 2.6% in December 2018 and December 2019. Hawaii's unemployment rate continued to be lower than the rate for the entire United States, which was 3.5% in December 2019. The growth in the visitor and construction industries have supported the local economy and kept the state's unemployment rate lower than the national rate. The construction of several new condominium projects and work on the City and County of Honolulu's mass transit project has increased employment in Hawaii's construction industry.

The number of single-family homes sold on the Island of Oahu, the primary real estate market in Hawaii, totaled 3,750 units in 2019, an increase of 3.9% compared to sales in 2018. The median price paid on Oahu for a single-family home in 2019 was \$789,000, a decrease of 0.1% compared to the median price in 2018. The number of condominium sales, a notable portion of the overall housing market, totaled 5,408 units in 2019, a decrease of 4.8% compared to sales in 2018. The median price paid on Oahu for condominiums in 2019 was \$425,000, an increase of 1.2% compared to the median price in 2018.

On the island of Maui, the second largest real estate market in Hawaii, sales of existing single-family homes totaled 1,117 units in 2019, a 1.9% decrease compared to the number of units sold in 2018. The median price paid for a single-family home on Maui in 2019 was \$741,000, an increase of 4.4% compared to the median price in 2018. The number of condominium sales totaled 1,606 units in 2019, a decrease of 3.1% compared to the number of units sold in 2018. The median price paid on Maui for condominiums in 2019 was \$516,000, a 3.1% increase compared to the median price in 2018.

In 2019, there were 1,666 bankruptcy filings in Hawaii, an increase of 11.8% compared to the number of filings in 2018. Although bankruptcy filings have risen in 2019, the total number of filings is considered to be relatively low. Several local economists believe the increase in bankruptcy filings is due to Hawaii's high cost of living and the improvement in the economy, leading people to spend more and to sometimes take on too much debt.

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, 2019 (the latest date for which information is publicly available), we ranked fifth in FDIC-insured deposit market share in the State of Hawaii (out of 13 banks and thrift institutions with offices in Hawaii), with a 3.8% 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 4.0% 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, 2019, \$1.5 billion, or 96.7% of our total loan portfolio, consisted of one- to four-family residential mortgage loans. We offer conforming, fixed-rate and adjustable-rate residential mortgage loans with maturities generally up to 30 years. There has been little demand for adjustable-rate mortgage loans in our market area.

One- to four-family residential mortgage loans are generally underwritten according to Fannie Mae and Freddie Mac guidelines, and we refer to loans that conform to such guidelines as “conforming loans.” We generally originate both fixed- and adjustable-rate mortgage loans in amounts up to the maximum conforming loan limits as established by the Federal Housing Finance Agency, which was \$726,525 for single-family homes located in the State of Hawaii for 2019. 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 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 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, 2019, we originated \$5.4 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 50 basis point reduction in points charged in connection with the loan. We also originate first mortgage loans to lower-income individuals who reside in rural census tracts where the U.S. Department of Agriculture will issue a second mortgage and complete the underwriting of the loan, subject to our review before origination. We also offer both Federal Housing Administration (FHA) and Veterans Administration (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. Home equity loans may be underwritten with a loan-to-value ratio of 80% when combined with the principal balance of the existing mortgage loan, while lines of credit for owner-occupied properties and investment properties may be underwritten with loan-to-value ratios of 80% and 65%, respectively, when combined with the principal balance of the

existing mortgage loan. At December 31, 2019, the outstanding balance of home equity loans totaled \$907,000, or 0.1% of our total loan portfolio, and the outstanding balance of home equity lines of credit totaled \$9.2 million, or 0.6% of our total loan portfolio.

Nonresidential Real Estate Loans. Our nonresidential real estate loans consist primarily of commercial real estate loans and construction loans for residential real estate projects. These loans totaled \$23.4 million, or 1.5% of our loan portfolio as of December 31, 2019. 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 \$11.1 million, or 0.7%, of our total loan portfolio at December 31, 2019, and consisted of 13 loans outstanding with an average loan balance of approximately \$851,000. All of our nonresidential real estate loans are secured by properties located in our primary market area. At December 31, 2019, our largest commercial real estate loan had a principal balance of \$2.9 million and was secured by real property and improvements utilized as an office building. This loan was performing in accordance with its original terms at December 31, 2019.

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, 2019, construction loans totaled \$7.6 million, or 0.5% of total loans receivable. At December 31, 2019, the additional unadvanced portion of these construction loans totaled \$3.2 million.

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

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

We sell loans to assist us in managing interest rate risk. We sold \$10.1 million and \$10.0 million of residential mortgage loans (all fixed-rate loans, with terms of 10 years or longer) during the years ended December 31, 2019 and 2018, respectively. We had one loan for \$470,000 classified as held for sale at December 31, 2019.

We sell our loans without recourse, except for normal representations and warranties provided in sales transactions. Since 2009, we have been selling loans primarily on a servicing released basis where servicing is transferred to a third party at the time the loan is sold. Prior to 2009, most of our loan sales were conducted on a servicing retained basis. At December 31, 2019, we were servicing loans owned by others with a principal balance of \$65.1 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, 2019, we received servicing fees of \$114,000. At December 31, 2019, substantially all of the loans serviced for Freddie Mac and Fannie Mae were performing in accordance with their contractual terms and we believe that there are no material repurchase obligations associated with these loans.

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

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

Territorial Savings Bank also uses automated systems to underwrite one- to four-family residential mortgage loans up to the maximum conforming loan limits as established by the Federal Housing Finance Agency, which was \$726,525 in the State of Hawaii for 2019. We require appraisals of all real property securing one- to four-family residential real estate loans, and on property securing home equity loans and lines of credit. All appraisers are licensed appraisers and all third-party appraisers are approved by the Board of Directors annually.

Investments

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

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

Our current policies do not permit hedging activities, such as engaging in futures, options or swap transactions, or investing in high-risk mortgage derivatives, such as collateralized mortgage obligation residual interests, real estate mortgage investment conduit residual interests or stripped mortgage-backed securities. As of December 31, 2019, we

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

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

Our held-to-maturity securities at December 31, 2019 consisted of mortgage-backed securities with a carrying value of \$363.9 million. At December 31, 2019, all of our mortgage-backed securities were issued by Fannie Mae, Freddie Mac or Ginnie Mae. At December 31, 2019, we had four securities totaling \$8.6 million classified as available-for-sale. At December 31, 2019, 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. The fair values of our securities are usually 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 guarantee 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 public deposits and borrowings. Investments in mortgage-backed securities involve a risk that actual payments will be greater or less than the prepayment rate estimated at the time of purchase, which may require adjustments to the amortization of any premium or accretion of any discount relating to such interests, thereby affecting the net yield on our securities.

Sources of Funds

General. Deposits traditionally have been our primary source of funds for our investment and lending activities. We also borrow from the FHLB 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 and security repayments, maturing investments, retained earnings, income on other earning assets and the proceeds of loan and security sales.

Deposits. At December 31, 2019, deposits totaled \$1.6 billion, or 88.6% of total liabilities. 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. 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.

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

Borrowings. Our borrowings consist of advances from the FHLB and funds borrowed from securities sold under agreements to repurchase. At December 31, 2019, our FHLB advances totaled \$156.0 million, or 8.5% of total liabilities, and securities sold under agreements to repurchase totaled \$10.0 million, or 0.5% of total liabilities. At December 31, 2019, we had access to additional FHLB advances of up to \$727.5 million. Advances from the FHLB are secured by our investment in the common stock of the FHLB 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 is authorized to engage in insurance activities. At December 31, 2019, Territorial Savings Bank's investment in Territorial Financial Services, Inc. was \$12,000, and Territorial Financial Services, Inc. had assets of \$75,000 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, 2019, we had 264 full-time employees and 17 part-time employees. Our employees are not represented by any collective bargaining group. Management believes that we have a good working relationship with our employees.

FEDERAL AND STATE TAXATION

Federal Taxation

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

Federal Tax Reform. The Tax Cuts and Jobs Act of 2017 includes a number of changes in tax law impacting businesses including, among other things, a reduction of the federal corporate income tax rate from 35% to 21% effective January 1, 2018. In addition to the reduction in the federal corporate income tax rate, stricter limits were placed on the tax deductibility of business meals and entertainment expenses for amounts paid or incurred on or after January 1, 2018.

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.

Alternative Minimum Tax. Prior to January 1, 2018, the Internal Revenue Code imposed an alternative minimum tax (AMT) at a rate of 20% on a base of regular taxable income plus certain tax preferences, which we refer to as "alternative minimum taxable income." The AMT is payable to the extent such alternative minimum taxable income is in excess of an exemption amount and the AMT exceeds the regular income tax. Net operating losses can offset no more than 90% of alternative minimum taxable income. Certain AMT payments may be used as credits against regular tax liabilities in future years. Effective January 1, 2018, the corporate AMT was repealed. At December 31, 2019, we did not have any AMT payments available to carry forward to future periods and under existing federal tax regulations, we do not expect to have any going forward.

Net Operating Loss Carryovers. Prior to January 1, 2018, subject to certain limitations, a company may carry back net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. For net operating losses generated beginning January 1, 2018, there are no carry backs allowed and an unlimited carry forward

period. At December 31, 2019, the Company did not have any net operating loss carry forwards 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. Tax years 2016 to 2018 currently remain subject to examination by the IRS.

State Taxation

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

Territorial Bancorp Inc.'s state franchise tax returns have not been audited in the most recent five-year period. Tax years 2016 to 2018 currently remain subject to examination by the Department of Taxation of the State of Hawaii.

SUPERVISION AND REGULATION

General

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

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

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

Certain 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.

Federal Banking Regulation

Capital Requirements. Federal regulations require that federally insured depository institutions meet several minimum capital standards: a common equity Tier 1 capital to risk-based assets ratio of 4.5%, a Tier 1 capital to risk-based assets ratio of 6.0%, a total capital to risk-based assets ratio of 8%, and a 4% Tier 1 capital to total assets leverage ratio. The current capital requirements were effective January 1, 2015 and are the result of a final rule implementing recommendations of the Basel Committee on Banking Supervision (BASEL III) and certain requirements of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

In determining the amount of risk-weighted assets for purposes of calculating risk-based capital ratios, all assets, including certain off-balance sheet assets (e.g., recourse obligations, direct credit substitutes, residual interests) are multiplied by a risk weight factor assigned by the regulations based on the risks believed inherent in the type of asset. Higher levels of capital are required for asset categories believed to present greater risk. Common equity Tier 1 capital is generally defined as common stockholders' equity and retained earnings. Tier 1 capital is generally defined as common equity Tier 1 and additional Tier 1 capital. Additional Tier 1 capital includes certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries. Total capital includes Tier 1 capital (common equity Tier 1 capital plus additional Tier 1 capital) and Tier 2 capital. Tier 2 capital is comprised of capital instruments and related surplus, meeting specified requirements, and may include cumulative preferred stock and long-term perpetual preferred stock, mandatory convertible securities, intermediate preferred stock and subordinated debt. Also included in Tier 2 capital is the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and, for institutions that have exercised an opt-out election regarding the treatment of accumulated other comprehensive income, up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Calculation of all types of regulatory capital is subject to deductions and adjustments specified in the regulations. In assessing an institution's capital adequacy, the Federal Reserve Bank takes into consideration, not only these numeric factors, but qualitative factors as well, and has the authority to establish higher capital requirements for individual institutions where deemed necessary.

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

At December 31, 2019, Territorial Savings Bank's regulatory capital exceeded that required by the capital requirements.

Legislation enacted in May 2018 requires the federal banking agencies, including the Federal Reserve Board, to establish a "community bank leverage ratio" of between 8 to 10% of average total consolidated assets for qualifying institutions with assets of less than \$10 billion. Institutions with capital meeting the specified requirements and electing to follow the alternative framework are deemed to comply with the applicable regulatory capital requirements, including the risk based requirements. The federal regulators issued a final rule that set the optional "community bank leverage ratio" at 9%.

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

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

- undercapitalized (less than 4% leverage capital, 6% Tier 1 risk-based capital, 8% total risk-based capital or 4.5% common equity Tier 1 risk-based capital);
- significantly undercapitalized (less than 3% leverage capital, 4% Tier 1 risk-based capital, 6% total risk-based capital or 3% common equity Tier 1 risk-based capital); and
- critically undercapitalized (less than 2% tangible capital).

At December 31, 2019, Territorial Savings Bank met the criteria for being considered “well-capitalized.”

The previously referenced final rule establishing an elective “community bank leverage ratio” regulatory capital requirement provides that a qualifying institution whose capital exceeds the community bank leverage ratio and opts to use that framework will be considered “well-capitalized” for purposes of prompt corrective action.

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

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

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

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

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

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

The Federal Deposit Insurance Corporation charges insured depository institutions premiums to maintain the Deposit Insurance Fund. Under the Federal Deposit Insurance Corporation’s risk-based assessment system, institutions deemed less risky pay lower assessments. Assessments for institutions of less than \$10 billion of assets are based on financial measures and supervisory ratings derived from statistical modeling estimating the probability of failure within three years. That system, effective July 1, 2016, replaced the previous system under which institutions were placed in risk categories.

The Dodd-Frank Act required the Federal Deposit Insurance Corporation to revise its procedures to base its assessments upon each insured institution's total assets less tangible equity instead of deposits. The Federal Deposit Insurance Corporation finalized a rule, effective April 1, 2011, that set the assessment range at 2.5 to 45 basis points of total assets less tangible equity. In conjunction with the Deposit Insurance Fund reserve ratio achieving 1.15%, the assessment range (inclusive of possible adjustments) was reduced for insured institutions of less than \$10 billion in total assets to 1.5 basis points to 30 basis points, effective July 1, 2016.

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 was required to seek to achieve the 1.35% ratio by September 30, 2020. The Federal Deposit Insurance Corporation indicated that the 1.35% ratio was exceeded in November 2018. The Dodd-Frank Act required insured institutions with assets of \$10 billion or more to fund the increase from 1.15% to 1.35% and, effective July 1, 2016, such institutions were subject to a surcharge to achieve that goal. Insured institutions of less than \$10 billion of assets are receiving credits for the portion of their assessments that contributed to increasing the reserve ratio between 1.15% and 1.35%. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the Federal Deposit Insurance Corporation, and the Federal Deposit Insurance Corporation has exercised that discretion by establishing a long-range fund ratio of 2%.

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

Federal Home Loan Bank System. Territorial Savings Bank is a member of the Federal Home Loan Bank System, which consists of eleven regional Federal Home Loan Banks. The FHLB 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 FHLB of Des Moines, Territorial Savings Bank is required to acquire and hold shares of capital stock in the FHLB. As of December 31, 2019, Territorial Savings Bank held \$8.7 million of capital stock in the FHLB of Des Moines and was in compliance with this requirement.

Hawaii Banking Regulation

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

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

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

Other Regulations

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

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- Real Estate Settlement Procedures Act, requiring that borrowers for mortgage loans for one- to four-family residential real estate receive various disclosures, including good faith estimates of settlement costs, lender

servicing and escrow account practices, and prohibiting certain practices that increase the cost of settlement services;

- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;
- fair lending laws;
- Unfair or Deceptive Acts or Practices laws and regulations;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;
- Truth in Savings Act; and
- rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

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

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services;
- Check Clearing for the 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 financial institutions 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 supervising savings and loan holding companies from the Office of Thrift Supervision to the Federal Reserve Board, effective July 21, 2011.

Permissible Activities. The business activities of Territorial Bancorp Inc. are generally limited to those activities permissible for financial holding companies under Section 4(k) of the Bank Holding Company Act of 1956, as amended, or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance as well as activities that are incidental to financial activities or complementary to a financial activity. The Dodd-Frank Act specifies 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. Territorial Bancorp Inc. has not elected financial holding company status. 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 generally prohibits the acquisition of more than 5% of a class of voting stock of a company engaged in impermissible activities.

Federal law prohibits a savings and loan holding company, including Territorial Bancorp Inc., from directly or indirectly, or through one or more subsidiaries, acquiring more than 5% of another savings institution or holding company thereof, without prior written approval of the Federal Reserve Board. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider, among others, the financial and managerial resources and 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 have historically not been subject to specific regulatory capital requirements. The Dodd-Frank Act required the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. Consolidated regulatory capital requirements identical to those applicable to the subsidiary depository institutions applied to savings and loan holding companies as of January 1, 2015. As is the case with institutions themselves, the capital conservation buffer for savings and loan holding companies was phased in between 2016 and 2019. However, legislation enacted in May 2018 required the Federal Reserve Board to raise the threshold of its "small holding company" exception to the applicability of consolidated holding company capital requirements from \$1 billion of consolidated assets to \$3 billion of consolidated assets. That change became effective in August 2018. Consequently, holding companies with less than \$3 billion of consolidated assets, including Territorial Bancorp, Inc., are generally not subject to the requirements unless otherwise advised by the Federal Reserve Board.

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

Dividends and Stock Repurchases. The Federal Reserve Board has issued a policy statement regarding the payment of dividends and the repurchase of shares of common stock by bank and savings and loan holding companies. In general, the policy provides that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. Regulatory guidance provides for prior regulatory review of capital distributions in certain circumstances, such as where the company's net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend. The guidance also provides for prior regulatory review where the company's overall rate of earnings retention is inconsistent with the company's capital needs and overall financial

condition. The ability of a holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. The policy statement also provides for regulatory review prior to a holding company redeeming or repurchasing regulatory capital instruments when the holding company is experiencing financial weaknesses or redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction in the amount of such equity instruments outstanding as of the end of a quarter compared with the beginning of the quarter in which the redemption or repurchase occurred. These regulatory policies could affect the ability of Territorial Bancorp Inc. to pay dividends, repurchase shares of common stock or otherwise engage in capital distributions.

Qualified Thrift Lender Test

In order for Territorial Bancorp Inc. to continue to be regulated as a savings and loan holding company (rather than bank holding company) when Territorial Savings Bank converted from a federal savings bank to a Hawaii savings bank, Territorial Savings Bank is required to satisfy the same qualified thrift lender (QTL) test that it did as federal savings bank. The QTL test requires Territorial Savings Bank to either qualify as a “domestic building and loan association” as defined by the Internal Revenue Code or maintain at least 65% of “portfolio assets” in “qualified thrift investments,” primarily residential mortgages and related investments, including mortgage-backed and related securities. Territorial Savings Bank was in compliance with the QTL test at December 31, 2019.

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

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

ITEM 1A. Risk Factors

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, 2019, 94.7% of our loans had maturities of 15 years or longer, while 66.9% 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. Furthermore, our loan origination and sales activity may be adversely affected by a rising interest rate environment that typically results in decreased loan demand. In a period of declining interest rates, the interest income earned on our assets likely will decrease more rapidly than the interest paid on our liabilities, as borrowers prepay mortgage loans and mortgage-backed securities, thereby requiring us to reinvest these cash flows at lower interest rates. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Management of Market Risk.”

In addition, changes in interest rates can affect the average life of loans and mortgage-backed and related securities and the fair value of mortgage servicing assets. A reduction in interest rates results in increased prepayments of loans and mortgage-backed and related securities, as borrowers refinance their loans 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 make it more difficult for borrowers to repay adjustable-rate loans. Potential reduction, or impairment, to the fair value of mortgage servicing assets generally occurs as market interest rates decline. Alternatively, an increase in market interest rates generally causes an increase in the fair value of mortgage servicing assets.

Changes in interest rates also affect the current fair value of our interest-earning securities portfolio. Generally, the value of securities moves inversely with changes in interest rates. At December 31, 2019, the fair value of our investment in held-to-maturity securities totaled \$371.3 million. Net unrealized gains on these securities totaled \$7.4 million at December 31, 2019. At December 31, 2019, our available-for-sale securities totaled \$8.6 million.

At December 31, 2019, 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 \$64.9 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, 2019, these loans totaled \$1.5 billion or 96.7% 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.

A worsening of economic conditions in our market area could reduce demand for our products and services and/or result in increases in our level of non-performing loans, which could adversely affect our operations, financial condition and earnings.

Local economic conditions have a significant impact on the ability of our borrowers to repay loans and the value of the collateral securing loans. A deterioration in economic conditions could have the following consequences, any of which could have a material adverse effect on our business, financial condition, liquidity and results of operations:

- demand for our products and services may decline;
- loan delinquencies, problem assets and foreclosures may increase;
- collateral for loans, especially real estate, may decline in value, thereby reducing customers' future borrowing power, and reducing the value of assets and collateral associated with existing loans;
- the value of our securities portfolio may decrease; and
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us.

Moreover, a significant decline in general economic conditions caused by inflation, recession, acts of terrorism, an outbreak of hostilities or other international or domestic calamities, unemployment or other factors beyond our control could further impact these local economic conditions and could further negatively affect the financial results of our banking operations. 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.

Monetary policies and regulations of the Federal Reserve Board could adversely affect our business, financial condition and results of operations.

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve Board. An important function of the Federal Reserve Board is to regulate the money supply and credit conditions. Among the instruments used by the Federal Reserve Board to implement these objectives are open market purchases and sales of U.S. government securities, adjustments of the federal funds and discount rates and changes in banks' reserve requirements against bank deposits. These instruments are used in varying combinations to influence overall economic growth and the distribution of credit, bank loans, investments and deposits. Their use also affects interest rates charged on loans or paid on deposits.

The monetary policies and regulations of the Federal Reserve Board have had a significant effect on the operating results of financial institutions in the past and are expected to continue to do so in the future. The effects of such policies upon our business, financial condition and results of operations cannot be predicted.

We are subject to the Community Reinvestment Act and fair lending laws, and failure to comply with these laws could lead to material penalties.

The Community Reinvestment Act (CRA), the Equal Credit Opportunity Act, the Fair Housing Act and other fair lending laws and regulations impose nondiscriminatory lending requirements on financial institutions. A successful regulatory challenge to an institution's performance under the CRA or fair lending laws and regulations could result in a wide variety of sanctions, including the required payment of damages and civil money penalties, injunctive relief, imposition of restrictions on mergers and acquisitions activity and restrictions on activities which could result in the denial of certain corporate applications such as branches. Private parties may also have the ability to challenge an institution's performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our business, financial condition and results of operations.

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

At December 31, 2019, our portfolio of commercial real estate, construction and other nonresidential real estate loans totaled \$23.4 million, or 1.5% of total loans. In addition, at December 31, 2019, our portfolio of commercial business loans totaled \$9.0 million, or 0.6% of total loans. These loans generally expose us to a greater risk of nonpayment and loss than residential real estate loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential real estate loans.

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

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

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

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

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and we evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, resulting in additions to our allowance. While our allowance for loan losses was 0.2% of total loans at December 31, 2019, material additions to our allowance could materially decrease our net income.

The Financial Accounting Standards Board has adopted a new accounting standard that will be effective for Territorial Bancorp Inc. and Territorial Savings Bank for our first fiscal year beginning after December 15, 2022. This standard, referred to as Current Expected Credit Loss (CECL), will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for loan losses. This will change the current method of providing allowances for loan losses that are probable, which may require us to increase our allowance for loan losses, and to greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for loan losses. Any increase in our allowance for loan losses or expenses incurred to determine the appropriate level of the allowance for loan losses may have a material adverse effect on our financial condition and results of operations.

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 appreciates up to the time shares are released, compensation expense relating to the employee stock ownership plan will increase and our net income will decline.

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

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

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

Tourism is the largest sector of Hawaii's economy. The Hawaii Tourism Authority reported visitor arrivals and visitor spending grew by 5.4% and 1.4%, respectively, from 2018 to 2019. 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.

The tourism industry can be affected by various factors, including the global economy and concerns over travel. For example, in December 2019, a novel strain of coronavirus was reported to have surfaced in Wuhan, China. The duration of business disruption and the effects on tourism cannot be reasonably estimated at this time, but could adversely affect our financial condition and results of operations.

Climate change is a long term risk to the State of Hawaii.

As a state surrounded by water, rising sea levels will impact coastline properties and properties subject to tidal flooding. That could negatively impact the real estate loans we have made on those properties. Furthermore, as tourism is the State's largest industry, climate change could negatively impact the weather of Hawaii, which is one of the leading reasons for visitors to travel to the State.

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.

The Federal Reserve Board may require us to commit capital resources to support Territorial Savings Bank.

Federal law requires that a holding company act as a source of financial and managerial strength to its subsidiary bank and to commit resources to support such subsidiary bank. Under the "source of strength" doctrine, the

Federal Reserve Board may require a holding company to make capital injections into a troubled subsidiary bank and may charge the holding company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank. A capital injection may be required at times when the holding company may not have the resources to provide it and therefore may be required to borrow the funds or raise capital. Any loans by a holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. In the event of a holding company's bankruptcy, the bankruptcy trustee will assume any commitment by the holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank. Moreover, bankruptcy law provides that claims based on any such commitment will be entitled to a priority of payment over the claims of the institution's general unsecured creditors, including the holders of its note obligations. Thus, any borrowing that must be done by Territorial Bancorp, Inc. to make a required capital injection becomes more difficult and expensive and could have an adverse effect on our business, financial condition and results of operations.

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

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

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

A final capital rule that became effective for financial institutions on January 1, 2015, included minimum risk-based capital and leverage ratios, and refined the definition of what constitutes "capital" for purposes of calculating these ratios. The minimum capital requirements are: (i) a common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6%; (iii) a total capital ratio of 8%; and (iv) a Tier 1 leverage ratio of 4%. The final rule also established a "capital conservation buffer" of 2.5%, resulting 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 capital conservation buffer requirement was fully implemented in January 2019. A financial institution, such as Territorial Savings Bank, is 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 establish a maximum percentage of eligible retained income that can be utilized for such actions.

Territorial Savings Bank and Territorial Bancorp Inc. met all of these requirements, including the full 2.5% capital conservation buffer, as of December 31, 2019.

The application of these 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. See "Supervision and Regulation—Federal Banking Regulation—Capital Distributions."

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

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 may 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.

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.

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

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions. In the past, 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.

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

The potential exists for additional federal or state laws and regulations, or changes in policy, regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Bank regulatory agencies, such as the Federal Reserve Board, the Hawaii Division of Financial Institutions and the Federal Deposit Insurance Corporation, govern the activities in which we may engage, primarily for the protection of depositors, and not for the protection or benefit of potential investors. In addition, new laws, regulations and other regulatory changes may increase our costs of regulatory compliance and of doing business, and otherwise 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 building of market share through de novo branching could cause our expenses to increase faster than revenues.

We intend to continue to build market share in the State of Hawaii through de novo branching. Since 2010, we have opened four de novo branches including the most recent branch opened in 2017. There are considerable costs involved in opening branches that generally require a period of time to generate the necessary revenues to offset their costs, especially in areas in which we do not have an established presence. Accordingly, any such business expansion can be expected to negatively impact our earnings for some period of time until certain economies of scale are reached. Our expenses could be further increased if we encounter delays in the opening of any of our new branches. Finally, our business expansion may not be successful after establishment.

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

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

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

Nevertheless, our systems 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. In addition, we outsource some of our data processing to certain third-party providers. If these third-party providers encounter difficulties, including as a result of cyber-attacks or information security breaches, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected.

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

Our risk management framework is designed to minimize risk and loss to us. We seek to identify, measure, monitor, report and control our exposure to risk, including strategic, market, liquidity, compliance and operational risks. While we use a broad and diversified set of risk monitoring and mitigation techniques, these techniques are inherently limited because they cannot anticipate the existence or future development of currently unanticipated or unknown risks. 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. In addition, employee errors and employee and customer misconduct could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes. Misconduct by our employees could include hiding unauthorized activities from us, improper or unauthorized activities on behalf of our customers or improper use of confidential information. It is not always possible to prevent employee errors and misconduct, and the precautions we take to prevent and detect this activity may not be effective in all cases. Employee errors could also subject us to financial claims for negligence. While we have policies and procedures designed to prevent such losses, losses may still occur.

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

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

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

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

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

The defense industry, the second largest contributor to Hawaii's economy after the visitor industry, accounts for about 9.8% of the state's gross domestic product. The defense industry creates thousands of jobs for residents of the State. Cuts to 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.

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

We must maintain sufficient funds to respond to the needs of depositors and borrowers. As a part of our liquidity management, we use a number of funding sources in addition to core deposit growth and repayments and maturities of loans and investments. As we continue to grow, we are likely to become more dependent on these sources, which may include FHLB advances, securities sold under agreements to repurchase, proceeds from the sale of loans,

federal funds purchased and brokered certificates of deposit. Adverse operating results or changes in industry conditions could lead to difficulty or an inability to access these additional funding sources. Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. If we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our operating margins and profitability would be adversely affected.

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

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

Changes in management's estimates and assumptions may have a material impact on our Consolidated Financial Statements and our financial condition or operating results.

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

A protracted government shutdown may result in reduced loan originations and related gains on sale and could negatively affect our financial condition and results of operations.

During any protracted federal government shutdown, we may not be able to close certain loans and we may not be able to recognize non-interest income on the sale of loans. Some of the loans we originate are sold directly to government agencies, and some of these sales may be unable to be consummated during the shutdown. In addition, we believe that some borrowers may determine not to proceed with their home purchase and not close on their loans, which would result in a permanent loss of the related non-interest income. A federal government shutdown could also result in reduced income for government employees or employees of companies that engage in business with the federal government, which could result in greater loan delinquencies, increases in our nonperforming and classified assets and a decline in demand for our products and services.

We depend on our management team and other key personnel to implement our business strategy and execute successful operations and we could be harmed by the loss of their services or the inability to hire additional personnel.

We are dependent upon the services of the members of our senior management team who direct our strategy and operations. Members of our senior management team, or lending personnel who possess expertise in our markets and key business relationships, could be difficult to replace. Our loss of these persons, or our inability to hire additional qualified personnel, could impact our ability to implement our business strategy and could have a material adverse effect on our results of operations and our ability to compete in our markets.

ITEM 1B. Unresolved Staff Comments

Not applicable.

ITEM 2. Properties

We operate from our corporate office in Honolulu, Hawaii, and from our 29 full-service branches located in the State of Hawaii. The net book value of our premises, land and equipment was \$4.4 million at December 31, 2019. The following table sets forth information with respect to all of our full-service banking offices. We lease all of our properties except for the Kailua Branch.

AINA HAINA
Aina Haina Shopping Center
820 West Hind Drive
Honolulu, Oahu 96821

KAIMUKI
1108 12th Avenue
Honolulu, Oahu 96816

KIHEI
Azeka Shopping Center
1279 South Kihei Road
Kihei, Maui 96753

PEARLRIDGE
98-084 Kamehameha Highway
Aiea, Oahu 96701

ALA MOANA CENTER
1450 Ala Moana Boulevard
Honolulu, Oahu 96814

KALIHI-KAPALAMA
1199 Dillingham Boulevard
Honolulu, Oahu 96817

KONA
Crossroads Shopping Center
75-1027 Henry Street
Kailua-Kona, Hawaii 96740

PIIKOI
1159 South Beretania Street
Honolulu, Oahu 96814

DOWNTOWN
1000 Bishop Street
Honolulu, Oahu 96813

**KAMEHAMEHA
SHOPPING CENTER**
1620 North School Street
Honolulu, Oahu 96817

LAHAINA
Old Lahaina Center
170 Papalaua Street
Lahaina, Maui 96761

SALT LAKE
Salt Lake Shopping Center
848 Ala Liliko'i Street
Honolulu, Oahu 96818

HAWAII KAI
Hawaii Kai Shopping Center
377 Keahole Street
Honolulu, Oahu 96825

KANEOHE
46-005 Kawa Street
Kaneohe, Oahu 96744

MANOA
Manoa Marketplace
2752 Woodlawn Drive
Honolulu, Oahu 96822

WAIPAHU
Waipahu Town Center
94-050 Farrington Highway
Waipahu, Oahu 96797

HILO
Waiakea Center
315 Makaala Street
Hilo, Hawaii 96720

KAPAHULU
Kilohana Square
1016 Kapahulu Avenue
Honolulu, Oahu 96816

McCULLY
1111 McCully Street
Honolulu, Oahu 96826

WAIPIO
Laniakea Plaza
94-1221 Ka Uka Boulevard
Waipahu, Oahu 96797

KAHALA
4819 Kilauea Avenue
Honolulu, Oahu 96816

KAPOLEI
Ace Center at Kapolei
480 Kamokila Boulevard
Kapolei, Oahu 96709

MILILANI
Town Center of Mililani
95-1249 Meheula Parkway
Mililani, Oahu 96789

KAHULUI
Queen Kaahumanu Center
275 W. Kaahumanu Avenue
Kahului, Maui 96732

KAUAI
Kukui Grove Shopping Center
4393 Kukui Grove Street
Lihue, Kauai 96766

NUUANU
Nuuanu Shopping Center
1613 Nuuanu Avenue
Honolulu, Oahu 96817

KAILUA
19 Oneawa Street
Kailua, Oahu 96734

KEEAUMOKU
735 Keeaumoku Street
Honolulu, Oahu 96814

PEARL CITY
Pearl City Shopping Center
850 Kamehameha Highway
Pearl City, Oahu 96782

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. At December 31, 2019, 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.

ITEM 4. Mine Safety Disclosures

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, 2020 was 1,063. 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.

(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.”

(e) **Stock Repurchases.** The following table sets forth information in connection with repurchases of our shares of common stock during the fourth quarter of 2019:

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Approximate Dollar Value of Shares That May Yet be Purchased Under the Plans or Programs (2) (3) |
|--|--|------------------------------------|--|---|
| October 1, 2019 through October 31, 2019 | 4,287 | \$ 29.47 | — | \$ 5,000,000 |
| November 1, 2019 through November 30, 2019 | 7,017 | 30.79 | — | \$ 5,000,000 |
| December 1, 2019 through December 31, 2019 | — | \$ — | — | \$ 5,000,000 |
| Total | 11,304 | \$ 30.29 | — | \$ 5,000,000 |

- (1) Includes shares acquired by the Company to settle the exercise price in connection with stock swap or net settlement transactions related to the exercise of stock options.
- (2) On May 3, 2019, the Company announced the completion of its eighth share repurchase program. Under this share repurchase program, the Company was authorized to repurchase up to \$5,000,000 of its outstanding shares.
- (3) On June 6, 2019, the Company announced its ninth share repurchase program. Under this share repurchase program, the Company is authorized to repurchase up to \$5,000,000 of our common stock based on certain price assumptions. We have entered into a Rule 10b5-1 plan with respect to our stock repurchase program.

ITEM 6. Selected Financial Data

The following selected financial data and ratios have been derived, in part, from the Consolidated Financial Statements and notes appearing elsewhere in this Annual Report on Form 10-K.

| | At December 31, | | | | |
|--|-----------------|--------------|--------------|--------------|--------------|
| | 2019 | 2018 | 2017 | 2016 | 2015 |
| | (In thousands) | | | | |
| Selected Financial Condition Data: | | | | | |
| Total assets | \$ 2,086,313 | \$ 2,069,206 | \$ 2,003,846 | \$ 1,877,562 | \$ 1,821,141 |
| Cash and cash equivalents | 44,806 | 47,063 | 32,089 | 61,273 | 65,919 |
| Investment securities held to maturity | 363,883 | 371,517 | 404,792 | 407,656 | 493,059 |
| Loans receivable, net | 1,584,784 | 1,574,714 | 1,488,971 | 1,335,987 | 1,188,649 |
| Bank-owned life insurance | 45,113 | 45,066 | 44,201 | 43,294 | 42,328 |
| Federal Home Loan Bank stock, at cost | 8,723 | 8,093 | 6,541 | 4,945 | 4,790 |
| Deposits | 1,631,933 | 1,629,164 | 1,597,295 | 1,493,200 | 1,445,103 |
| Advances from the Federal Home Loan Bank | 156,000 | 142,200 | 107,200 | 69,000 | 69,000 |
| Securities sold under agreements to repurchase | 10,000 | 30,000 | 30,000 | 55,000 | 55,000 |
| Total stockholders' equity | 243,890 | 235,079 | 234,854 | 229,786 | 219,641 |

| | Year Ended December 31, | | | | |
|---|-------------------------|-----------|-----------|-----------|-----------|
| | 2019 | 2018 | 2017 | 2016 | 2015 |
| | (In thousands) | | | | |
| Selected Operating Data: | | | | | |
| Interest income | \$ 75,568 | \$ 73,301 | \$ 68,333 | \$ 66,073 | \$ 63,092 |
| Interest expense | 17,027 | 13,529 | 9,589 | 7,844 | 6,515 |
| Net interest income | 58,541 | 59,772 | 58,744 | 58,229 | 56,577 |
| Provision for loan losses | 61 | 119 | 52 | 310 | 455 |
| Net interest income after provision for loan losses | 58,480 | 59,653 | 58,692 | 57,919 | 56,122 |
| Noninterest income | 7,832 | 3,164 | 3,846 | 4,094 | 4,911 |
| Noninterest expense | 38,006 | 37,494 | 36,474 | 34,879 | 36,499 |
| Income before income taxes | 28,306 | 25,323 | 26,064 | 27,134 | 24,534 |
| Income taxes | 6,311 | 6,111 | 11,102 | 10,787 | 9,786 |
| Net income | \$ 21,995 | \$ 19,212 | \$ 14,962 | \$ 16,347 | \$ 14,748 |

At or for the Year Ended December 31,

| | 2019 | 2018 | 2017 | 2016 | 2015 |
|---|----------|----------|----------|----------|----------|
| Selected Financial Ratios and Other Data: | | | | | |
| Performance Ratios: | | | | | |
| Return on average assets (ratio of net income to average total assets) | 1.06 % | 0.95 % | 0.77 % | 0.88 % | 0.84 % |
| Return on average equity (ratio of net income to average equity) | 9.04 % | 8.14 % | 6.34 % | 7.20 % | 6.75 % |
| Interest rate spread (1) | 2.80 % | 2.94 % | 3.07 % | 3.19 % | 3.29 % |
| Net interest margin (2) | 2.93 % | 3.05 % | 3.15 % | 3.26 % | 3.36 % |
| Efficiency ratio (3) | 57.26 % | 59.57 % | 58.27 % | 55.96 % | 59.36 % |
| Noninterest expense to average total assets | 1.83 % | 1.85 % | 1.89 % | 1.88 % | 2.08 % |
| Average interest-earning assets to average interest-bearing liabilities | 115.44 % | 114.92 % | 115.50 % | 115.66 % | 115.86 % |
| Average equity to average total assets | 11.71 % | 11.62 % | 12.20 % | 12.25 % | 12.46 % |
| Basic earnings per share | \$ 2.38 | \$ 2.07 | \$ 1.61 | \$ 1.80 | \$ 1.63 |
| Diluted earnings per share | \$ 2.34 | \$ 2.03 | \$ 1.57 | \$ 1.76 | \$ 1.59 |
| Dividend payout ratio (4) | 63.40 % | 56.16 % | 76.43 % | 52.27 % | 47.80 % |
| Asset Quality Ratios: | | | | | |
| Nonperforming assets to total assets | 0.04 % | 0.11 % | 0.21 % | 0.24 % | 0.30 % |
| Nonperforming loans to total loans | 0.05 % | 0.14 % | 0.28 % | 0.34 % | 0.45 % |
| Allowance for loan losses to nonperforming loans | 368.48 % | 119.39 % | 60.28 % | 53.78 % | 40.00 % |
| Allowance for loan losses to total loans | 0.17 % | 0.17 % | 0.17 % | 0.18 % | 0.18 % |
| Capital Ratios (bank-level only): | | | | | |
| Total capital (to risk-weighted assets) | 23.59 % | 23.78 % | 23.59 % | 25.59 % | 26.07 % |
| Common equity Tier 1 capital (to risk-weighted assets) | 23.31 % | 23.50 % | 23.31 % | 25.30 % | 25.79 % |
| Tier I capital (to risk-weighted assets) | 23.31 % | 23.50 % | 23.31 % | 25.30 % | 25.79 % |
| Tier I capital (to total assets) | 10.92 % | 11.09 % | 11.04 % | 11.76 % | 11.49 % |
| Other Data: | | | | | |
| Number of full-service offices | 29 | 29 | 29 | 28 | 28 |
| Full-time equivalent employees | 273 | 277 | 276 | 271 | 275 |

- (1) The average interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average 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 dividend payout ratio represents cash dividends declared per share divided by diluted earnings per share.

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 Consolidated Financial Statements that appear elsewhere in this Annual Report on Form 10-K.

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 inflows, cash balances at the Federal Reserve Bank, loan and securities repayments, advances from the Federal Home Loan Bank, proceeds from securities sold under agreements to repurchase and proceeds from loan and security sales. As a result, we may be vulnerable to increases in interest rates, as our interest-bearing liabilities mature or reprice more quickly than our interest-earning assets.

We have continued our focus on originating one- to four-family residential real estate loans. Our emphasis on conservative loan underwriting has resulted in continued low levels of nonperforming assets. Our nonperforming assets, which can include nonaccrual loans and real estate owned, totaled \$736,000, or 0.04% of total assets at December 31, 2019, compared to \$2.2 million, or 0.11% of total assets at December 31, 2018. As of December 31, 2019, nonperforming assets consisted of six mortgage loans with a principal balance of \$736,000. Our nonperforming loans and loan 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 \$61,000 and \$119,000 for the years ended December 31, 2019 and 2018, respectively.

Our operations are affected by our efforts to manage our interest rate risk position. In 2019 and 2018, we sold \$10.1 million and \$10.0 million, respectively, of fixed-rate mortgage loans. In 2019 and 2018, we obtained \$19.0 million and \$86.6 million, respectively, of long-term public deposits. In 2019 and 2018, we increased our long-term FHLB borrowings by \$121.0 million and \$5.0 million, respectively, to reduce interest rate risk. See “—Management of Market Risk” for a discussion of the actions we have taken in managing interest rate risk.

All of Territorial Savings Bank’s investments in mortgage-backed securities and collateralized mortgage obligations have been issued by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. These agencies guarantee the payment of principal and interest on the Bank’s mortgage-backed securities. We do not own any preferred stock issued by Fannie Mae or Freddie Mac. As of December 31, 2019 and 2018, our additional borrowing capacity at the FHLB of Des Moines was \$727.5 million and \$769.3 million, respectively.

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.

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, as an integral part of their examination processes, the bank regulators will periodically review our allowance for loan losses. The bank regulators may require that we recognize additions to the allowance for loan losses based on their

analysis of 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. 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 pricing models that consider bid and ask prices and prices at which similar securities traded.

We evaluated our \$8.7 million investment in FHLB stock for other-than-temporary impairment as of December 31, 2019. Considering the long-term nature of this investment and the liquidity position of the FHLB of Des Moines, our FHLB stock was not considered to be other-than-temporarily impaired. As of December 31, 2019, the FHLB of Des Moines has met all of its regulatory capital requirements. Moody's Investor Services has given the FHLB of Des Moines a long-term credit rating of Aaa.

We evaluated our \$3.1 million investment in FRB stock for other-than-temporary impairment as of December 31, 2019. Based on the long-term nature of this investment and the liquidity position of the FRB of San Francisco, our FRB stock was not considered to be other-than-temporarily impaired.

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

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

At December 31, 2019, we used weighted-average discount rates of 4.30% and 3.30% for calculating annual pension expense and projected plan liabilities, respectively, and an expected long-term rate of return on plan assets of 7.25% for calculating annual pension expense. At December 31, 2018, we used weighted-average discount rates of 3.70% and 4.30% for calculating annual pension expense and projected plan liabilities, respectively, and an expected long-term rate of return on plan assets of 7.25% 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 have reduced our pension expense in 2019, 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 have decreased our 2019 pension expense by \$8,000 and would have increased our year-end 2019 pension liability by \$606,000, while a 25 basis point decrease in the asset return rate would have increased our 2019 pension expense by \$42,000.

Balance Sheet Analysis

Assets. At December 31, 2019, our assets were \$2.1 billion, an increase of \$17.1 million, or 0.8%, from December 31, 2018. The increase was primarily caused by an increase of \$10.1 million in loans receivable and recording a net \$11.6 million right-of-use asset related to leases. These increases were partially offset by decreases of \$2.3 million in cash and cash equivalents and \$1.6 million in total investment securities.

Cash and Cash Equivalents. At December 31, 2019, we had \$44.8 million of cash and cash equivalents compared to \$47.1 million at December 31, 2018. During 2019, cash and cash equivalents decreased by \$2.3 million primarily due to \$13.7 million in dividends paid, funding a net increase of \$10.1 million in loans receivable, a \$6.2 million net decrease in borrowings and the repurchase of \$1.6 million of common stock. These decreases in cash and cash equivalents were partially offset by \$22.0 million in net income, a \$2.8 million increase in deposits and a \$1.6 million decrease in total investment securities.

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

| | At December 31, | | | | | |
|---------------------------------------|------------------------|----------|--------------|----------|--------------|----------|
| | 2019 | 2018 | 2017 | 2016 | 2015 | |
| | Amount | Percent | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | \$ 1,536,781 | 96.66 % | \$ 1,531,149 | 96.88 % | \$ 1,444,625 | 96.65 % |
| Multi-family residential | 9,965 | 0.63 | 12,151 | 0.77 | 10,799 | 0.72 |
| Construction, commercial and other | 23,382 | 1.47 | 20,780 | 1.31 | 21,787 | 1.46 |
| Home equity loans and lines of credit | 10,084 | 0.63 | 11,090 | 0.70 | 12,882 | 0.86 |
| Other loans | 9,719 | 0.61 | 5,296 | 0.34 | 4,614 | 0.31 |
| Total loans | 1,589,931 | 100.00 % | 1,580,466 | 100.00 % | 1,494,707 | 100.00 % |
| Other items: | | | | | | |
| Unearned fees and discounts, net | (2,435) | | (3,110) | | (3,188) | |
| Allowance for loan losses | (2,712) | | (2,642) | | (2,548) | |
| Loans receivable, net | \$ 1,584,784 | | \$ 1,574,714 | | \$ 1,488,971 | |
| | | | | | \$ 1,335,987 | |
| | | | | | 1,194,902 | 100.00 % |
| | | | | | 1,145,904 | 95.90 % |
| | | | | | 9,834 | 0.82 |
| | | | | | 19,288 | 1.62 |
| | | | | | 15,333 | 1.28 |
| | | | | | 4,543 | 0.38 |

Loan Portfolio Maturities and Yields. The following table summarizes the scheduled maturities of our loan portfolio at December 31, 2019. Demand loans, loans having no stated repayment schedule or maturity, and overdraft loans are reported as being due in one year or less.

| Due During the Years Ending December 31, | One- to four-family residential real estate | | Multi-family residential real estate | | Construction, commercial and other real estate | | Home equity loans and lines of credit | | Other loans | | Total | |
|---|--|-----------------------------|---|-----------------------------|---|-----------------------------|--|-----------------------------|-----------------|-----------------------------|---------------------|-----------------------------|
| | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate |
| 2020 | \$ 29 | 5.11 % | \$ — | — % | \$ 2,206 | 5.00 % | \$ 276 | 7.23 % | \$ 502 | 7.54 % | \$ 3,013 | 5.63 % |
| 2021 to 2024 | 1,517 | 4.93 | 2,443 | 5.50 | 3,434 | 5.23 | 1,927 | 7.05 | 2,120 | 5.56 | 11,441 | 5.62 |
| 2025 and beyond | 1,535,235 | 3.86 | 7,522 | 4.36 | 17,742 | 4.54 | 7,881 | 5.33 | 7,097 | 4.79 | 1,575,477 | 3.88 |
| Total | \$ 1,536,781 | 3.86 % | \$ 9,965 | 4.64 % | \$ 23,382 | 4.69 % | \$ 10,084 | 5.71 % | \$ 9,719 | 5.10 % | \$ 1,589,931 | 3.90 % |

The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at December 31, 2019 that are contractually due after December 31, 2020.

| | <u>Due After December 31, 2020</u> | | |
|---------------------------------------|------------------------------------|-------------------------|----------------------------|
| | <u>Fixed</u> | <u>Adjustable</u> | <u>Total</u> |
| | (In thousands) | | |
| Real estate loans: | | | |
| First mortgage: | | | |
| One- to four-family residential | \$ 1,535,622 | \$ 1,130 | \$ 1,536,752 |
| Multi-family residential | 9,292 | 673 | 9,965 |
| Construction, commercial and other | 19,562 | 1,614 | 21,176 |
| Home equity loans and lines of credit | 907 | 8,901 | 9,808 |
| Other loans | 8,603 | 614 | 9,217 |
| Total loans | <u>\$ 1,573,986</u> | <u>\$ 12,932</u> | <u>\$ 1,586,918</u> |

Securities. At December 31, 2019, our securities portfolio totaled \$372.5 million, or 17.9% of assets and included \$363.9 million of held-to-maturity securities and \$8.6 million of available-for-sale securities. All of the mortgage-backed securities were issued by Fannie Mae, Freddie Mac or Ginnie Mae. At December 31, 2019, 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, 2019, we held no common or preferred stock of Fannie Mae or Freddie Mac.

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

| | <u>At December 31,</u> | | | | | |
|--|---------------------------|--------------------------|---------------------------|--------------------------|---------------------------|--------------------------|
| | <u>2019</u> | | <u>2018</u> | | <u>2017</u> | |
| | <u>Amortized Cost</u> | <u>Fair Value</u> | <u>Amortized Cost</u> | <u>Fair Value</u> | <u>Amortized Cost</u> | <u>Fair Value</u> |
| | (In thousands) | | | | | |
| Available for Sale: | | | | | | |
| U.S. government sponsored mortgage-backed securities: | | | | | | |
| Freddie Mac | \$ 7,905 | \$ 8,628 | \$ 2,644 | \$ 2,560 | \$ 2,870 | \$ 2,851 |
| Total | <u>\$ 7,905</u> | <u>\$ 8,628</u> | <u>\$ 2,644</u> | <u>\$ 2,560</u> | <u>\$ 2,870</u> | <u>\$ 2,851</u> |
| Held to Maturity: | | | | | | |
| U.S. government sponsored mortgage-backed securities: | | | | | | |
| Fannie Mae | \$ 110,497 | \$ 112,446 | \$ 119,536 | \$ 117,079 | \$ 127,768 | \$ 128,069 |
| Freddie Mac | 218,966 | 224,271 | 211,365 | 208,015 | 229,120 | 231,051 |
| Collateralized mortgage obligations (1) | 3,964 | 3,865 | 4,877 | 4,608 | 5,992 | 5,744 |
| Ginnie Mae | 30,456 | 30,723 | 35,664 | 34,517 | 41,485 | 40,954 |
| Total U.S. government sponsored mortgage-backed securities | 363,883 | 371,305 | 371,442 | 364,219 | 404,365 | 405,818 |
| Trust preferred securities | — | — | 75 | 703 | 427 | 845 |
| Total | <u>\$ 363,883</u> | <u>\$ 371,305</u> | <u>\$ 371,517</u> | <u>\$ 364,922</u> | <u>\$ 404,792</u> | <u>\$ 406,663</u> |

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

Our trust preferred security investment was sold in 2019. A gain of \$2.7 million was recognized on the sale.

Any unrealized loss on individual mortgage-backed securities as of December 31, 2019 and 2018 was caused by increases in market interest rates. All of our mortgage-backed securities are guaranteed by U.S. government-sponsored enterprises or a U.S. government agency. Since the decline in market value has been attributable to changes in interest rates and not credit quality, we continue to have the intent not to sell these investments, and it is not more likely than not that we will be required to sell such investments prior to the recovery of the amortized cost basis, we have not considered these investments to be other-than-temporarily impaired as of December 31, 2019 and 2018.

At December 31, 2019, 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.

Portfolio Maturities and Coupons. The composition and maturities of the investment securities portfolio at December 31, 2019 are summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur. No tax-equivalent adjustments have been made, as we did not hold any tax-free investment securities at December 31, 2019.

| | One Year or Less | | More than One Year through Five Years | | More than Five Years through Ten Years | | More than Ten Years | | Total Securities | | |
|--|------------------|-------------------------|---------------------------------------|-------------------------|--|-------------------------|---------------------|-------------------------|------------------|------------|--------|
| | Amortized Cost | Weighted Average Coupon | Amortized Cost | Weighted Average Coupon | Amortized Cost | Weighted Average Coupon | Amortized Cost | Weighted Average Coupon | Amortized Cost | Fair Value | |
| (Dollars in thousands) | | | | | | | | | | | |
| Available for Sale: | | | | | | | | | | | |
| U.S. government sponsored mortgage-backed securities: | | | | | | | | | | | |
| Freddie Mac | \$ — | — % | \$ — | — % | \$ — | — % | \$ 8,628 | 4.00 % | \$ 8,628 | \$ 8,628 | 4.00 % |
| Total | \$ — | — % | \$ — | — % | \$ — | — % | \$ 8,628 | 4.00 % | \$ 8,628 | \$ 8,628 | 4.00 % |
| Held to Maturity: | | | | | | | | | | | |
| U.S. government sponsored mortgage-backed securities: | | | | | | | | | | | |
| Fannie Mae | \$ — | — % | \$ — | — % | \$ 47 | 4.48 % | \$ 110,450 | 3.11 % | \$ 110,497 | \$ 112,446 | 3.11 % |
| Freddie Mac | — | — | 1 | 5.00 | — | — | 218,965 | 3.08 | 218,966 | 224,271 | 3.08 |
| Collateralized mortgage obligations (1) | — | — | — | — | — | — | 3,964 | 1.65 | 3,964 | 3,865 | 1.65 |
| Ginnie Mae | — | — | — | — | 13 | 3.65 | 30,443 | 2.91 | 30,456 | 30,723 | 2.91 |
| Total U.S. government sponsored mortgage-backed securities | — | — | 1 | 5.00 | 60 | 4.30 | 363,822 | 3.06 | 363,883 | 371,305 | 3.06 |
| Total | \$ — | — % | \$ 1 | 5.00 % | \$ 60 | 4.30 % | \$ 363,822 | 3.06 % | \$ 363,883 | \$ 371,305 | 3.06 % |

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

Bank-Owned Life Insurance. We invest in bank-owned life insurance to provide us with a funding source for our benefit plan obligations. Bank-owned life insurance also generally provides us noninterest income that is nontaxable. Interagency federal guidance generally limits our investment in bank-owned life insurance to 25% of the Bank's Tier 1 capital plus our allowance for loan losses. At December 31, 2019, this limit was \$57.6 million, and we had invested \$45.1 million in bank-owned life insurance at that date.

Deposits. At December 31, 2019, deposits totaled \$1.6 billion or 88.6% of total liabilities. 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, and do not currently have, brokered 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.

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, 2019, our deposits grew by \$2.8 million, or 0.2%. The growth in deposits was primarily due to increases of \$72.8 million in the balance of certificates of deposit and \$10.3 million in checking accounts, which were partially offset by an \$83.1 million decrease in passbook savings for the year ended December 31, 2019. The increase in certificates of deposit and the decrease in passbook savings accounts occurred as some customers transferred funds to certificates of deposit with higher interest rates.

At December 31, 2019, we had a total of \$463.9 million in certificates of deposit, of which \$310.5 million had remaining maturities of one year or less. Based on historical experience and our current pricing strategy, we believe we will retain a significant portion of these accounts upon maturity.

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

| | For the Year Ended December 31, | | | | | |
|-------------------------|---------------------------------|----------------|-----------------------|---------------------|----------------|-----------------------|
| | 2019 | | | 2018 | | |
| | Average Balance | Percent | Weighted Average Rate | Average Balance | Percent | Weighted Average Rate |
| | (Dollars in thousands) | | | | | |
| Deposit type: | | | | | | |
| Non-interest-bearing | \$ 52,501 | 3.2 % | — % | \$ 51,063 | 3.1 % | — % |
| Savings accounts | 939,159 | 57.4 | 0.49 % | 1,019,966 | 62.9 | 0.47 % |
| Certificates of deposit | 447,898 | 27.4 | 1.97 % | 362,699 | 22.4 | 1.68 % |
| Money market | 5,034 | 0.3 | 0.44 % | 5,673 | 0.3 | 0.44 % |
| Checking and Super NOW | 190,667 | 11.7 | 0.02 % | 183,277 | 11.3 | 0.02 % |
| Total deposits | <u>\$ 1,635,259</u> | <u>100.0 %</u> | 0.85 % | <u>\$ 1,622,678</u> | <u>100.0 %</u> | 0.70 % |

| | For the Year Ended December 31, 2017 | | |
|-------------------------|--------------------------------------|----------------|-----------------------|
| | Average Balance | Percent | Weighted Average Rate |
| | (Dollars in thousands) | | |
| Deposit type: | | | |
| Non-interest-bearing | \$ 47,148 | 3.1 % | — % |
| Savings accounts | 1,033,454 | 67.2 | 0.43 % |
| Certificates of deposit | 270,225 | 17.6 | 1.17 % |
| Money market | 5,171 | 0.3 | 0.44 % |
| Checking and Super NOW | 180,858 | 11.8 | 0.02 % |
| Total deposits | <u>\$ 1,536,856</u> | <u>100.0 %</u> | 0.51 % |

As of December 31, 2019, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to \$250,000 was \$272.7 million. The following table sets forth the maturity of those certificates as of December 31, 2019.

| | <u>At December 31, 2019</u> (In thousands) |
|--------------------------------------|---|
| Three months or less | \$ 79,900 |
| Over three months through six months | 68,488 |
| Over six months through one year | 39,354 |
| Over one year to three years | 80,362 |
| Over three years | <u>4,629</u> |
| Total | <u>\$ 272,733</u> |

Borrowings. Our borrowings consist of advances from the FHLB and funds borrowed under securities sold under agreements to repurchase. At December 31, 2019, our FHLB advances totaled \$156.0 million, or 8.5% of total liabilities, and our securities sold under agreements to repurchase totaled \$10.0 million, or 0.5% of total liabilities. At December 31, 2019, we had the capability to borrow up to \$727.5 million in the form of additional advances from the Federal Home Loan Bank.

During the year ended December 31, 2019, our total borrowings decreased by \$6.2 million or 3.6%. The decrease was due to a decrease in securities sold under agreements to repurchase, which was partially offset by an increase in FHLB advances. We primarily funded our operations with additional deposits, borrowings, 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 FHLB advances at the dates and for the years indicated.

| | <u>At or for the Year Ended December 31,</u> | | |
|---|--|-------------|-------------|
| | <u>2019</u> | <u>2018</u> | <u>2017</u> |
| | (Dollars in thousands) | | |
| Balance at end of year | \$ 156,000 | \$ 142,200 | \$ 107,200 |
| Average balance during year | \$ 138,181 | \$ 106,159 | \$ 73,416 |
| Maximum outstanding at any month end | \$ 183,900 | \$ 142,200 | \$ 107,200 |
| Weighted average interest rate at end of year | 2.27 % | 2.35 % | 1.70 % |
| Average interest rate during year | 2.42 % | 1.89 % | 1.51 % |

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.

| | <u>At or for the Year Ended December 31,</u> | | |
|---|--|-------------|-------------|
| | <u>2019</u> | <u>2018</u> | <u>2017</u> |
| | (Dollars in thousands) | | |
| Balance at end of year | \$ 10,000 | \$ 30,000 | \$ 30,000 |
| Average balance during year | \$ 12,808 | \$ 30,000 | \$ 51,315 |
| Maximum outstanding at any month end | \$ 30,000 | \$ 30,000 | \$ 55,000 |
| Weighted average interest rate at end of year | 1.77 % | 1.66 % | 1.66 % |
| Average interest rate during year | 1.75 % | 1.68 % | 1.59 % |

Stockholders' Equity. At December 31, 2019, our stockholders' equity was \$243.9 million, an increase of \$8.8 million, or 3.7%, from \$235.1 million at December 31, 2018. The increase in stockholders' equity occurred as our net income and the increase in capital from the exercise of stock options and allocation of ESOP shares exceeded dividends paid to shareholders and share repurchases.

Average Balances and Yields

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

| | For the Year Ended December 31, 2019 | | |
|--|---|--|-------------|
| | Average Outstanding Balance | Interest (Dollars in thousands) | Yield/ Rate |
| Interest-earning assets: | | | |
| Loans: | | | |
| Real estate loans: | | | |
| First mortgage: | | | |
| One- to four-family residential (1) | \$ 1,539,289 | \$ 60,558 | 3.93 % |
| Multi-family residential | 11,755 | 542 | 4.61 |
| Construction, commercial and other | 21,462 | 1,019 | 4.75 |
| Home equity loans and lines of credit | 11,196 | 636 | 5.68 |
| Other loans | 7,396 | 382 | 5.16 |
| Total loans | 1,591,098 | 63,137 | 3.97 |
| Investment securities: | | | |
| U.S. government sponsored mortgage-backed securities (1) | 371,844 | 11,459 | 3.08 |
| Trust preferred securities | 3 | — | 0.00 |
| Total securities | 371,847 | 11,459 | 3.08 |
| Other | 38,447 | 972 | 2.53 |
| Total interest-earning assets | 2,001,392 | 75,568 | 3.78 |
| Non-interest-earning assets | 77,075 | | |
| Total assets | \$ 2,078,467 | | |
| Interest-bearing liabilities: | | | |
| Savings accounts | \$ 939,159 | 4,593 | 0.49 % |
| Certificates of deposit | 447,898 | 8,807 | 1.97 |
| Money market accounts | 5,034 | 22 | 0.44 |
| Checking and Super NOW accounts | 190,667 | 41 | 0.02 |
| Total interest-bearing deposits | 1,582,758 | 13,463 | 0.85 |
| Federal Home Loan Bank advances | 138,181 | 3,346 | 2.42 |
| Securities sold under agreements to repurchase | 12,808 | 218 | 1.70 |
| Total interest-bearing liabilities | 1,733,747 | 17,027 | 0.98 |
| Non-interest-bearing liabilities | 101,396 | | |
| Total liabilities | 1,835,143 | | |
| Stockholders' equity | 243,324 | | |
| Total liabilities and stockholders' equity | \$ 2,078,467 | | |
| Net interest income | | \$ 58,541 | |
| Net interest rate spread (2) | | | 2.80 % |
| Net interest-earning assets (3) | \$ 267,645 | | |
| Net interest margin (4) | | | 2.93 % |
| Interest-earning assets to interest-bearing liabilities | 115.44 % | | |

(footnotes on following page)

| | For the Year Ended December 31, | | | | | |
|--|---------------------------------|------------------|-------------|-----------------------------|------------------|-------------|
| | 2018 | | | 2017 | | |
| | Average Outstanding Balance | Interest | Yield/ Rate | Average Outstanding Balance | Interest | Yield/ Rate |
| | (Dollars in thousands) | | | | | |
| Interest-earning assets: | | | | | | |
| Loans: | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential (1) | \$ 1,480,279 | \$ 57,827 | 3.91 % | \$ 1,357,508 | \$ 52,751 | 3.89 % |
| Multi-family residential | 11,086 | 505 | 4.56 | 9,572 | 448 | 4.68 |
| Construction, commercial and other | 22,799 | 1,073 | 4.71 | 22,603 | 1,032 | 4.57 |
| Home equity loans and lines of credit | 12,267 | 629 | 5.13 | 13,930 | 654 | 4.69 |
| Other loans | 4,543 | 245 | 5.39 | 4,925 | 259 | 5.26 |
| Total loans | <u>1,530,974</u> | <u>60,279</u> | 3.94 | <u>1,408,538</u> | <u>55,144</u> | 3.91 |
| Investment securities: | | | | | | |
| U.S. government sponsored mortgage-backed securities (1) | 395,279 | 12,236 | 3.10 | 403,537 | 12,526 | 3.10 |
| Trust preferred securities | 213 | — | 0.00 | 868 | — | 0.00 |
| Total securities | <u>395,492</u> | <u>12,236</u> | 3.09 | <u>404,405</u> | <u>12,526</u> | 3.10 |
| Other | 36,102 | 786 | 2.18 | 51,686 | 663 | 1.28 |
| Total interest-earning assets | <u>1,962,568</u> | <u>73,301</u> | 3.73 | <u>1,864,629</u> | <u>68,333</u> | 3.66 |
| Non-interest-earning assets | 68,320 | | | 69,887 | | |
| Total assets | <u>\$ 2,030,888</u> | | | <u>\$ 1,934,516</u> | | |
| Interest-bearing liabilities: | | | | | | |
| Savings accounts | \$ 1,019,966 | 4,841 | 0.47 % | \$ 1,033,454 | 4,445 | 0.43 % |
| Certificates of deposit | 362,699 | 6,109 | 1.68 | 270,225 | 3,159 | 1.17 |
| Money market accounts | 5,673 | 25 | 0.44 | 5,171 | 23 | 0.44 |
| Checking and Super NOW accounts | 183,277 | 40 | 0.02 | 180,858 | 39 | 0.02 |
| Total interest-bearing deposits | <u>1,571,615</u> | <u>11,015</u> | 0.70 | <u>1,489,708</u> | <u>7,666</u> | 0.51 |
| Federal Home Loan Bank advances | 106,159 | 2,010 | 1.89 | 73,416 | 1,105 | 1.51 |
| Securities sold under agreements to repurchase | 30,000 | 504 | 1.68 | 51,315 | 818 | 1.59 |
| Total interest-bearing liabilities | <u>1,707,774</u> | <u>13,529</u> | 0.79 | <u>1,614,439</u> | <u>9,589</u> | 0.59 |
| Non-interest-bearing liabilities | 87,086 | | | 84,000 | | |
| Total liabilities | <u>1,794,860</u> | | | <u>1,698,439</u> | | |
| Stockholders' equity | 236,028 | | | 236,077 | | |
| Total liabilities and stockholders' equity | <u>\$ 2,030,888</u> | | | <u>\$ 1,934,516</u> | | |
| Net interest income | | <u>\$ 59,772</u> | | | <u>\$ 58,744</u> | |
| Net interest rate spread (2) | | | 2.94 % | | | 3.07 % |
| Net interest-earning assets (3) | <u>\$ 254,794</u> | | | <u>\$ 250,190</u> | | |
| Net interest margin (4) | | | 3.05 % | | | 3.15 % |
| Interest-earning assets to interest-bearing liabilities | | 114.92 % | | | 115.50 % | |

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

(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.

Rate/Volume Analysis

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

| | Year Ended December 31, 2019 vs. 2018 | | | Year Ended December 31, 2018 vs. 2017 | | |
|--|--|------------|---------------------------------|--|------------|---------------------------------|
| | Increase (Decrease) Due to | | Total Increase (Decrease) | Increase (Decrease) Due to | | Total Increase (Decrease) |
| | Volume | Rate | | Volume | Rate | |
| | (In thousands) | | | | | |
| Interest-earning assets: | | | | | | |
| Loans: | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | \$ 2,320 | 411 | 2,731 | \$ 4,795 | 281 | 5,076 |
| Multi-family residential | 31 | 6 | 37 | 69 | (12) | 57 |
| Construction, commercial and other | (64) | 10 | (54) | 9 | 32 | 41 |
| Home equity loans and lines of credit | (30) | 37 | 7 | (108) | 83 | (25) |
| Other loans | 147 | (10) | 137 | (22) | 8 | (14) |
| Total loans | 2,404 | 454 | 2,858 | 4,743 | 392 | 5,135 |
| U.S. government sponsored mortgage-backed securities | (723) | (54) | (777) | (256) | (34) | (290) |
| Other | 53 | 133 | 186 | (94) | 217 | 123 |
| Total interest-earning assets | 1,734 | 533 | 2,267 | 4,393 | 575 | 4,968 |
| Interest-bearing liabilities: | | | | | | |
| Savings accounts | (404) | 156 | (248) | (57) | 453 | 396 |
| Certificates of deposit | 1,575 | 1,123 | 2,698 | 1,290 | 1,660 | 2,950 |
| Money market accounts | (3) | — | (3) | 2 | — | 2 |
| Checking and Super NOW accounts | 2 | (1) | 1 | 1 | — | 1 |
| Total interest-bearing deposits | 1,170 | 1,278 | 2,448 | 1,236 | 2,113 | 3,349 |
| Federal Home Loan Bank advances | 694 | 642 | 1,336 | 573 | 332 | 905 |
| Securities sold under agreements to repurchase | (293) | 7 | (286) | (361) | 47 | (314) |
| Total interest-bearing liabilities | 1,571 | 1,927 | 3,498 | 1,448 | 2,492 | 3,940 |
| Change in net interest income | \$ 163 | \$ (1,394) | \$ (1,231) | \$ 2,945 | \$ (1,917) | \$ 1,028 |

Comparison of Operating Results for the Years Ended December 31, 2019 and 2018

General. Net income increased by \$2.8 million, or 14.5%, to \$22.0 million for the year ended December 31, 2019 from \$19.2 million for the year ended December 31, 2018. The increase in net income was primarily due to a \$4.7 million increase in noninterest income, which was partially offset by a \$1.2 million decrease in net interest income.

Net Interest Income. Net interest income decreased by \$1.2 million, or 2.1%, to \$58.5 million for the year ended December 31, 2019 from \$59.8 million for the year ended December 31, 2018. Interest income increased by \$2.3 million, or 3.1%, to \$75.6 million for the year ended December 31, 2019 from \$73.3 million for the year ended December 31, 2018. The increase in interest income occurred primarily because of a \$38.8 million increase in average

interest-earning assets, which was augmented by a five basis point increase in the average yield on interest-earning assets. Interest expense increased by \$3.5 million, or 25.9%, to \$17.0 million for the year ended December 31, 2019 from \$13.5 million for the year ended December 31, 2018. The increase in interest expense was due to a 19 basis point increase in the average cost of interest-bearing liabilities and a \$26.0 million increase in average interest-bearing liabilities. The interest rate spread and net interest margin were 2.80% and 2.93%, respectively, for the year ended December 31, 2019, compared to 2.94% and 3.05%, respectively, for the year ended December 31, 2018. The decreases in the interest rate spread and net interest margin were primarily due to an increase in the cost of average interest-bearing liabilities.

Interest Income. Interest income rose by \$2.3 million, or 3.1%, to \$75.6 million for the year ended December 31, 2019 from \$73.3 million for the year ended December 31, 2018. Interest income on loans increased by \$2.9 million, or 4.7%, to \$63.1 million for the year ended December 31, 2019 from \$60.3 million for the year ended December 31, 2018. The increase in interest income on loans occurred because the average balance of loans grew by \$60.1 million, or 3.9%, as new loan originations exceeded loan repayments, sales and securitizations. The increase in interest income that occurred because of growth in the loan portfolio was augmented by a three basis point increase in the average loan yield to 3.97% for the year ended December 31, 2019 compared to 3.94% for the year ended December 31, 2018. The increase in the average yield on loans occurred because of the origination of new loans with higher yields. Interest income on investment securities decreased by \$777,000, or 6.4%, to \$11.5 million for the year ended December 31, 2019 from \$12.2 million for the year ended December 31, 2018. The decrease in interest income on securities occurred primarily because of a \$23.6 million decrease in the average securities balance. The decrease in the average securities balance occurred as repayments and security sales exceeded security purchases and loan securitizations. The repayments on securities were reinvested into higher yielding loans.

Interest Expense. Interest expense increased by \$3.5 million, or 25.9%, to \$17.0 million for the year ended December 31, 2019 from \$13.5 million for the year ended December 31, 2018. Interest expense on certificates of deposits increased by \$2.7 million, or 44.2%, to \$8.8 million for the year ended December 31, 2019 from \$6.1 million for the year ended December 31, 2018. The increase in interest expense on certificates of deposit occurred because of a 29 basis point increase in the average cost of certificates of deposit and an \$85.2 million increase in the average balance of certificates of deposit. Interest expense on FHLB advances increased by \$1.3 million, or 66.5%, during the year ended December 31, 2019 compared to the year ended December 31, 2018. The increase in interest expense on FHLB advances was due to a \$32.0 million increase in the average balance of FHLB advances and a 53 basis point increase in the average cost of FHLB advances. The increase in the average cost of advances occurred primarily because of rising FHLB advance rates. Interest expense on securities sold under agreements to repurchase declined by \$286,000, or 56.7%, during the year ended December 31, 2019 compared to the year ended December 31, 2018. The decrease in interest expense on securities sold under agreements to repurchase was caused by a \$17.2 million, or 57.3%, decrease in the average outstanding balance of securities sold under agreements to repurchase. The decline in the average balance of securities sold under agreements to repurchase occurred as matured borrowings were paid off in 2019.

Provision for Loan Losses. Based on our analysis of the factors described in “—Allowance for Loan Losses,” we recorded provisions for loan losses of \$61,000 and \$119,000 for the years ended December 31, 2019 and 2018, respectively. The decrease in loan loss provisions from 2018 to 2019 is primarily due to a decrease in nonperforming loans and relatively low levels of loan losses. The provisions for loan losses included net recoveries of \$9,000 for the year ended December 31, 2019 and net charge-offs of \$25,000 for year ended December 31, 2018. The provisions recorded resulted in ratios of the allowance for loan losses to total loans of 0.17% at December 31, 2019 and December 31, 2018. Nonaccrual loans totaled \$736,000 and \$2.2 million at December 31, 2019 and 2018, respectively. To the best of our knowledge, at December 31, 2019 and 2018, 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, 2019 and 2018.

| | Year Ended December 31, | | Change 2019/2018 | |
|---|-------------------------|----------|------------------|-----------|
| | 2019 | 2018 | \$ Change | % Change |
| | (Dollars in thousands) | | | |
| Service fees on loan and deposit accounts | \$ 1,937 | \$ 1,886 | \$ 51 | 2.7 % |
| Income on bank-owned life insurance | 835 | 865 | (30) | (3.5)% |
| Gain on sale of investment securities | 2,910 | 45 | 2,865 | 6,366.7 % |
| Gain on sale of loans | 1,540 | 72 | 1,468 | 2,038.9 % |
| Other | 610 | 296 | 314 | 106.1 % |
| Total | \$ 7,832 | \$ 3,164 | \$ 4,668 | 147.5 % |

Noninterest income increased by \$4.7 million for the year ended December 31, 2019 compared to the year ended December 31, 2018. During the year ended December 31, 2019, we sold our investment in a trust preferred security and recognized a gain of \$2.7 million. The sale of this trust preferred security, which had a significant deterioration in the issuer's credit rating, is in accordance with the Investments — Debt and Equity Securities topic of the FASB ASC and does not taint management's assertion of its intent to hold the remaining securities in the held-to-maturity portfolio to maturity. The \$1.5 million gain on sale of loans occurred when we securitized mortgage loans with a book value of \$36.8 million into mortgage-backed securities. The gain on the loan securitization transactions occurred as the fair value of the mortgage-backed securities and the mortgage servicing assets, which were capitalized, exceeded the amortized cost of the mortgage loans. Other income increased primarily due to bank-owned life insurance proceeds.

Noninterest Expense. The following table summarizes changes in noninterest expense for the years ended December 31, 2019 and 2018.

| | Year Ended December 31, | | Change 2019/2018 | |
|---|-------------------------|-----------|------------------|----------|
| | 2019 | 2018 | \$ Change | % Change |
| | (Dollars in thousands) | | | |
| Salaries and employee benefits | \$ 22,580 | \$ 22,159 | \$ 421 | 1.9 % |
| Occupancy | 6,400 | 6,324 | 76 | 1.2 % |
| Equipment | 4,183 | 3,980 | 203 | 5.1 % |
| Federal deposit insurance premiums | 288 | 608 | (320) | (52.6)% |
| Other general and administrative expenses | 4,555 | 4,423 | 132 | 3.0 % |
| Total | \$ 38,006 | \$ 37,494 | \$ 512 | 1.4 % |

Noninterest expense increased by \$512,000 to \$38.0 million for the year ended December 31, 2019 from \$37.5 million for the year ended December 31, 2018. Salaries and employee benefits expense increased by \$421,000 for the year primarily due to increases in compensation expense, stock benefit plan expenses and health insurance. These increases were partially offset by an increase in the capitalized cost of new loan originations and a decrease in the expense for our employee stock ownership plan. More loans were originated in 2019 than in 2018 and the increase in new loan originations raised the credit to compensation expense for the cost of new loan originations. Equipment expense increased primarily due to an increase in information technology expenses. The increase in other general and administrative expenses was mainly due to increases in professional fees. The reduction in federal deposit insurance premiums occurred when we received credits because the FDIC insurance fund was over-capitalized.

Income Tax Expense. Income tax expense for 2019 was \$6.3 million with an effective tax rate of 22.3% compared to \$6.1 million with an effective tax rate of 24.1% in 2018. Income tax expense for 2019 included a \$402,000 tax benefit that occurred when we filed an amended 2017 corporate tax return that included an increase in depreciation expense. The additional depreciation expense occurred when we conducted a study that reduced the asset lives used to calculate depreciation. We filed an amended return and were able to deduct the increase in depreciation expense at the 2017 federal corporate tax rate of 35% rather than the current 21% federal corporate tax rate. Income tax expense for 2019 also included \$297,000 of tax benefits from the exercise of stock options. In addition, we received \$419,000 of

proceeds on bank-owned life insurance in 2019 that were not taxable and lowered the effective tax rate. Income tax expense for 2018 included a \$476,000 tax benefit from a \$3.4 million pension contribution to our defined benefit pension plan. The 2017 Tax Cuts and Jobs Act allowed the tax deduction for the pension contribution to be calculated at the 2017 corporate tax rate of 35% rather than the current federal tax rate of 21%. Income tax expense for 2018 also included \$134,000 of tax benefits from the exercise of stock options.

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 121st 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.

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 consumer loans are generally unsecured, we may commence collection procedures earlier for consumer loans than for residential mortgage loans or home equity lines of credit.

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

Nonperforming Assets. The table below sets forth the amounts and categories of our nonperforming assets (loans and real estate owned) at the dates indicated.

| | At December 31, | | | | |
|--|------------------------|-----------------|-----------------|-----------------|-----------------|
| | 2019 | 2018 | 2017 | 2016 | 2015 |
| | (Dollars in thousands) | | | | |
| Nonaccrual loans: | | | | | |
| Real estate loans: | | | | | |
| First mortgage: | | | | | |
| One- to four-family residential | \$ 647 | \$ 2,065 | \$ 4,062 | \$ 4,402 | \$ 5,282 |
| Home equity loans and lines of credit | 89 | 148 | 165 | 156 | 124 |
| Other loans | — | — | — | 1 | 9 |
| Total nonaccrual loans | <u>736</u> | <u>2,213</u> | <u>4,227</u> | <u>4,559</u> | <u>5,415</u> |
| Real estate owned: | | | | | |
| Real estate loans: | | | | | |
| First mortgage: | | | | | |
| One- to four-family residential | — | — | — | — | — |
| Total real estate owned | — | — | — | — | — |
| Total nonperforming assets | <u>736</u> | <u>2,213</u> | <u>4,227</u> | <u>4,559</u> | <u>5,415</u> |
| Loans delinquent 90 days or greater and still accruing interest | — | — | — | — | — |
| Restructured loans still accruing interest: | | | | | |
| Real estate loans: | | | | | |
| First mortgage: | | | | | |
| One- to four-family residential | 577 | 897 | 915 | 1,185 | 1,203 |
| Total restructured loans still accruing interest | <u>577</u> | <u>897</u> | <u>915</u> | <u>1,185</u> | <u>1,203</u> |
| Total nonperforming assets, accruing loans delinquent for 90 days or more and restructured loans still accruing interest | <u>\$ 1,313</u> | <u>\$ 3,110</u> | <u>\$ 5,142</u> | <u>\$ 5,744</u> | <u>\$ 6,618</u> |
| Ratios: | | | | | |
| Nonperforming loans to total loans | 0.05 % | 0.14 % | 0.28 % | 0.34 % | 0.45 % |
| Nonperforming assets to total assets | 0.04 % | 0.11 % | 0.21 % | 0.24 % | 0.30 % |

For the year ended December 31, 2019, gross interest income that would have been recorded had our nonaccruing loans been current in accordance with original terms was \$60,000. For the year ended December 31, 2019, we recognized no interest income on such nonaccruing loans on a cash basis during the year. For the year ended December 31, 2019, gross interest income due and collected on our accruing restructured loans was \$34,000.

We had six troubled debt restructurings totaling \$1.2 million as of December 31, 2019 that were considered to be impaired. This total included five one- to four-family residential mortgage loans totaling \$1.1 million and one home equity loan for \$64,000. Three of the loans, totaling \$577,000, were performing in accordance with their restructured terms and accruing interest at December 31, 2019. Three of the loans, totaling \$589,000, were performing in accordance with their restructured terms but not accruing interest at December 31, 2019. We had eight troubled debt restructurings totaling \$1.7 million as of December 31, 2018 that were considered to be impaired. This total included seven one- to four-family residential mortgage loans totaling \$1.6 million and one home equity loan for \$78,000. Four of the loans, totaling \$897,000, were performing in accordance with their restructured terms and accruing interest at December 31, 2018. Four of the loans, totaling \$769,000, were performing in accordance with their restructured terms but not accruing interest at December 31, 2018. There were no new troubled debt restructurings in 2019 or 2018.

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

| | Loans Delinquent For | | | | Total | |
|---------------------------------------|----------------------|-----------------|------------------|-----------------|-----------|-----------------|
| | 60-89 Days | | 90 Days and Over | | Number | Amount |
| | Number | Amount | Number | Amount | | |
| (Dollars in thousands) | | | | | | |
| <u>At December 31, 2019</u> | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | 5 | \$ 959 | — | \$ — | 5 | \$ 959 |
| Home equity loans and lines of credit | 1 | 26 | — | — | 1 | 26 |
| Other loans | 4 | 1 | 1 | 1 | 5 | 2 |
| Total loans | <u>10</u> | <u>\$ 986</u> | <u>1</u> | <u>\$ 1</u> | <u>11</u> | <u>\$ 987</u> |
| <u>At December 31, 2018</u> | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | 1 | \$ 292 | 2 | \$ 838 | 3 | \$ 1,130 |
| Home equity loans and lines of credit | 1 | 29 | 1 | 41 | 2 | 70 |
| Other loans | 5 | 4 | — | — | 5 | 4 |
| Total loans | <u>7</u> | <u>\$ 325</u> | <u>3</u> | <u>\$ 879</u> | <u>10</u> | <u>\$ 1,204</u> |
| <u>At December 31, 2017</u> | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | 4 | \$ 1,207 | 4 | \$ 1,589 | 8 | \$ 2,796 |
| Home equity loans and lines of credit | — | — | 1 | 41 | 1 | 41 |
| Other loans | 6 | — | — | — | 6 | — |
| Total loans | <u>10</u> | <u>\$ 1,207</u> | <u>5</u> | <u>\$ 1,630</u> | <u>15</u> | <u>\$ 2,837</u> |
| <u>At December 31, 2016</u> | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | 1 | \$ 133 | 4 | \$ 1,358 | 5 | \$ 1,491 |
| Home equity loans and lines of credit | 1 | 35 | 2 | 49 | 3 | 84 |
| Other loans | 4 | — | 1 | 1 | 5 | 1 |
| Total loans | <u>6</u> | <u>\$ 168</u> | <u>7</u> | <u>\$ 1,408</u> | <u>13</u> | <u>\$ 1,576</u> |
| <u>At December 31, 2015</u> | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | — | \$ — | 6 | \$ 1,615 | 6 | \$ 1,615 |
| Home equity loans and lines of credit | — | — | — | — | — | — |
| Other loans | 3 | 1 | 1 | 10 | 4 | 11 |
| Total loans | <u>3</u> | <u>\$ 1</u> | <u>7</u> | <u>\$ 1,625</u> | <u>10</u> | <u>\$ 1,626</u> |

Real Estate Owned. Real estate acquired by us as a result of foreclosure or by deed in lieu of foreclosure is classified as real estate owned. When property is acquired it is recorded at estimated fair value at the date of foreclosure less the cost to sell, establishing a new cost basis. Estimated fair value generally represents the price a buyer would be willing to pay on the basis of current market conditions, including normal terms from other financial institutions. Holding costs and declines in estimated fair value result in charges to expense after acquisition. At December 31, 2019, 2018, 2017, 2016, and 2015, we had no real estate owned.

Classification of Assets. Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or the fair value of collateral pledged, if any. Substandard assets include those assets characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets (or portions of assets) classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted.

We maintain an allowance for loan losses at an amount estimated to equal all credit losses incurred in our loan portfolio that are both probable and reasonable to estimate at a balance sheet date. Our determination as to the classification of our assets and the amount of our loss allowances is subject to review by bank regulators, who can require that we establish additional loss allowances. We regularly review our asset portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of our review of our assets at December 31, 2019, we had substandard assets of \$1.1 million, loss assets of \$1,000 and no doubtful assets. Substandard assets at December 31, 2019 included \$788,000 of troubled debt restructurings and \$360,000 of nonperforming loans. At December 31, 2018, we had \$3.0 million of substandard assets and no doubtful or loss assets. Substandard assets at December 31, 2018 included \$1.3 million of troubled debt restructurings, \$1.7 million of nonperforming loans and \$75,000 of trust preferred securities. We classify any loan that is delinquent 90 days or more as substandard. Loans which have been delinquent for fewer days may also be classified as substandard.

In addition to classifying assets as substandard, doubtful or loss, we also categorize assets as special mention. A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. We designate any loan that is 30 to 89 days delinquent as special mention. Loans which have been delinquent for fewer days may also be categorized as special mention. At December 31, 2019 and 2018, special mention assets were \$973,000 and \$433,000, respectively.

Allowance for Loan Losses

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

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

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

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

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

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

- home equity loans and lines of credit; and
- consumer and other loans.

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

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

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

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

| (Dollars in thousands) | At or For the Year Ended December 31, | | | | |
|---|---------------------------------------|----------|----------|----------|----------|
| | 2019 | 2018 | 2017 | 2016 | 2015 |
| Balance at beginning of year | \$ 2,642 | \$ 2,548 | \$ 2,452 | \$ 2,166 | \$ 1,691 |
| Charge-offs: | | | | | |
| Real estate loans: | | | | | |
| First mortgage: | | | | | |
| One- to four-family residential | 8 | 12 | 11 | 33 | — |
| Home equity loans and lines of credit | — | — | — | — | — |
| Other loans | 40 | 29 | 26 | 28 | 53 |
| Total charge-offs | 48 | 41 | 37 | 61 | 53 |
| Recoveries: | | | | | |
| Real estate loans: | | | | | |
| First mortgage: | | | | | |
| One- to four-family residential | 36 | 10 | 75 | 24 | 3 |
| Construction, commercial and other | — | — | — | 1 | 11 |
| Home equity loans and lines of credit | — | — | — | — | 47 |
| Other loans | 21 | 6 | 6 | 12 | 12 |
| Total recoveries | 57 | 16 | 81 | 37 | 73 |
| Net (charge-offs) recoveries | 9 | (25) | 44 | (24) | 20 |
| Provision for loan losses | 61 | 119 | 52 | 310 | 455 |
| Balance at end of year | \$ 2,712 | \$ 2,642 | \$ 2,548 | \$ 2,452 | \$ 2,166 |
| Ratios: | | | | | |
| Net charge-offs to average loans outstanding | — % | — % | — % | — % | — % |
| Allowance for loan losses to nonperforming loans at end of year | 368.48 % | 119.39 % | 60.28 % | 53.78 % | 40.00 % |
| Allowance for loan losses to total loans at end of year | 0.17 % | 0.17 % | 0.17 % | 0.18 % | 0.18 % |

Allocation of Allowance for Loan Losses. The following tables set forth the allowance for loan losses allocated by loan category and the percent of loans in each category to total loans at the dates indicated. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category. The allowance for loan losses for each category is affected by the national and Hawaii economies as well as other factors. The allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

| | At December 31, | | | | | |
|---------------------------------------|------------------------------|---|------------------------------|---|------------------------------|---|
| | 2019 | | 2018 | | 2017 | |
| | Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans |
| (Dollars in thousands) | | | | | | |
| Real estate loans: | | | | | | |
| First mortgage: | | | | | | |
| One- to four-family residential | \$ 1,730 | 96.66 % | \$ 1,781 | 96.88 % | \$ 1,706 | 96.65 % |
| Multi-family residential | 11 | 0.63 | 16 | 0.77 | 15 | 0.72 |
| Construction, commercial and other | 511 | 1.47 | 443 | 1.31 | 539 | 1.46 |
| Home equity loans and lines of credit | 1 | 0.63 | 1 | 0.70 | 1 | 0.86 |
| Other loans | 54 | 0.61 | 47 | 0.34 | 55 | 0.31 |
| Total allocated allowance | 2,307 | 100.00 | 2,288 | 100.00 | 2,316 | 100.00 |
| Unallocated | 405 | — | 354 | — | 232 | — |
| Total | \$ 2,712 | 100.00 % | \$ 2,642 | 100.00 % | \$ 2,548 | 100.00 % |

| | At December 31, | | | |
|---------------------------------------|------------------------------|---|------------------------------|---|
| | 2016 | | 2015 | |
| | Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans |
| (Dollars in thousands) | | | | |
| Real estate loans: | | | | |
| First mortgage: | | | | |
| One- to four-family residential | \$ 1,579 | 96.11 % | \$ 1,365 | 95.90 % |
| Multi-family residential | 15 | 0.71 | 15 | 0.82 |
| Construction, commercial and other | 519 | 1.74 | 517 | 1.62 |
| Home equity loans and lines of credit | 2 | 1.10 | 3 | 1.28 |
| Other loans | 115 | 0.34 | 72 | 0.38 |
| Total allocated allowance | 2,230 | 100.00 | 1,972 | 100.00 |
| Unallocated | 222 | — | 194 | — |
| Total | \$ 2,452 | 100.00 % | \$ 2,166 | 100.00 % |

Management of Market Risk

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

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

We continue our efforts to reduce interest rate risk. In 2019 and 2018, we sold \$10.1 million and \$10.0 million, respectively, of fixed-rate mortgage loans. In 2019 and 2018, we obtained \$19.0 million and \$86.6 million, respectively, of long-term public deposits. In 2019 and 2018, we increased our long-term FHLB borrowings by \$121.0 million and \$5.0 million, respectively, to reduce our interest rate risk. In addition, we may utilize the following strategies to further reduce our interest rate risk:

- Continuing our efforts to increase our core checking and passbook accounts, which are less rate-sensitive than certificates of deposit and which provide us with a stable, low-cost source of funds;
- Continuing to repay short-term borrowings;
- Maintaining overnight cash balances at the Federal Reserve Bank or a portfolio of short-term investments;
- Purchasing mortgage-backed securities with shorter durations;
- Selling a portion of the fixed-rate mortgage loans we originate to Freddie Mac or Fannie Mae;
- Extending the maturity of our liabilities by obtaining longer-term fixed-rate public deposits, FHLB advances and securities sold under agreements to repurchase;
- Subject to the maintenance of our credit quality standards, originating commercial loans and home equity lines of credit, which have adjustable interest rates and shorter average lives than first mortgage loans; and
- Maintaining relatively high regulatory capital ratios.

Our policies do not permit hedging activities, such as engaging in futures, options or swap transactions, or investing in high-risk mortgage derivatives, such as collateralized mortgage obligation residual interests, real estate mortgage investment conduit residual interests or stripped mortgage-backed securities. We do not have any current plans to sell loans classified as held-for-investment.

Economic Value of Equity. We use an interest rate sensitivity analysis that computes changes in the economic value of equity (EVE) of our cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. EVE represents the market value of portfolio equity and is equal to the present value of assets minus the present value of liabilities, with adjustments made for off-balance sheet items. This analysis assesses the risk of loss in market-risk-sensitive instruments in the event of an instantaneous and sustained 100 to 400 basis point increase or a 100 to 200 basis point decrease in market interest rates with no effect given to any steps that we might take to counter the effect of that interest rate movement. A basis point equals one-hundredth of one percent, and 100 basis points equals one percent. An increase in interest rates from 3% to 4% would mean, for example, a 100 basis point increase in the “Change in Interest Rates” column below. Given the current relatively low level of market interest rates, an EVE calculation for an interest rate decrease of greater than 200 basis points has not been prepared.

The following table presents our internal calculations of the estimated changes in our EVE as of December 31, 2019 that would result from the designated instantaneous changes in the interest rate yield curve.

| Change in Interest Rates (bp) (1) | Estimated EVE (2) | Estimated Increase (Decrease) in EVE | Percentage Change in EVE | EVE Ratio as a Percent of Present Value of Assets (3)(4) | Increase (Decrease) in EVE Ratio as a Percent of Present Value of Assets (3)(4) |
|-----------------------------------|-------------------|--------------------------------------|--------------------------|--|---|
| (Dollars in thousands) | | | | | |
| +400 | \$ 141,370 | \$ (167,124) | (54.17)% | 8.44 % | (6.16)% |
| +300 | \$ 188,604 | \$ (119,890) | (38.86)% | 10.59 % | (4.01)% |
| +200 | \$ 243,593 | \$ (64,901) | (21.04)% | 12.82 % | (1.78)% |
| +100 | \$ 291,381 | \$ (17,113) | (5.55)% | 14.44 % | (0.16)% |
| 0 | \$ 308,494 | \$ — | — % | 14.60 % | — % |
| (100) | \$ 282,746 | \$ (25,748) | (8.35)% | 13.02 % | (1.58)% |
| (200) | \$ 210,182 | \$ (98,312) | (31.87)% | 9.60 % | (5.00)% |

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

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

Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations. Territorial Savings Bank's primary sources of funds consist of deposit inflows, cash balances at the FRB, loan and security repayments, advances from the FHLB, securities sold under agreements to repurchase, proceeds from loan and security sales and principal repayments on securities. We also have the capability of securitizing mortgage loans that conform to Freddie Mac loan underwriting standards into mortgage-backed securities. These securities can either be sold or pledged as collateral for public deposits and borrowings to increase the Bank's cash on hand. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We have established an Asset/Liability Management Committee, consisting of our President and Chief Executive Officer, our Vice Chairman and Co-Chief Operating Officer, our Senior Vice President and Chief Financial Officer and our Vice President and Controller, which is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of December 31, 2019.

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

- (i) expected loan demand;
- (ii) purchases and sales of investment securities;
- (iii) expected deposit flows and borrowing maturities;

- (iv) yields available on interest-earning deposits and securities; and
- (v) the objectives of our asset/liability management program.

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

Our most liquid asset is cash. The amount of this asset is dependent on our operating, financing, lending and investing activities during any given period. At December 31, 2019, the Company's cash and cash equivalents totaled \$44.8 million.

If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLB, which provide an additional source of funds. We also utilize securities sold under agreements to repurchase as another borrowing source. At December 31, 2019, we had the ability to borrow up to an additional \$727.5 million from the FHLB. Advances from the FHLB and securities sold under agreements to repurchase were \$156.0 million and \$10.0 million, respectively for the year ended December 31, 2019. In 2019, FHLB advances increased by \$13.8 million while securities sold under agreements to repurchase decreased by \$20.0 million. The increase in FHLB advances was used primarily to reduce our interest rate risk.

At December 31, 2019, we had \$55.0 million in standby letters of credit from the FHLB pledged as collateral for State of Hawaii deposits. At December 31, 2018 we did not have any standby letters of credit from the FHLB.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our Consolidated Statements of Cash Flows included in our Consolidated Financial Statements.

At December 31, 2019, we had \$8.7 million in loan commitments outstanding, most of which were for fixed-rate loans. In addition to commitments to originate loans, we had \$24.5 million in unused lines of credit to borrowers. Certificates of deposit due within one year of December 31, 2019 totaled \$310.5 million, or 19.0% of total deposits. If these deposits do not remain with us, we may be required to seek other sources of funds, including loan sales, brokered deposits, securities sold under agreements to repurchase and FHLB advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2020. We believe, however, based on past experience that a significant portion of such deposits will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

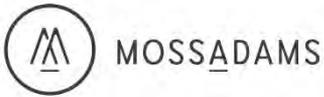
Our primary investing activities are originating loans and purchasing mortgage-backed securities. During the years ended December 31, 2019 and 2018, we originated \$249.1 million and \$232.5 million of loans, respectively. In 2019 and 2018, we purchased \$9.2 million and \$15.0 million of securities, respectively.

Financing activities consist primarily of activity in deposit accounts, FHLB advances, securities sold under agreements to repurchase, stock repurchases and dividend payments. We experienced net increases in deposits of \$2.8 million and \$31.9 million for the years ended December 31, 2019 and 2018, respectively. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

As a separate legal entity, the Company is required to have liquidity to fund stock repurchases and dividend payments to shareholders and for other corporate purposes. As of December 31, 2019, we can purchase up to \$5.0 million of shares under our current share repurchase program. Shares repurchased will reduce the amount of shares issued and outstanding. The repurchased shares may be reissued in connection with share-based compensation plans and for general corporate purposes. During the years ended December 31, 2019 and 2018, the Company repurchased 59,700 and 303,500 shares of common stock, respectively, at an average cost of \$26.74 and \$30.36, respectively, as part of the repurchase programs authorized by the Board of Directors. At December 31, 2019 and 2018, on a stand-alone basis, the Company had cash in banks of \$22.6 million and \$16.4 million, respectively.

Territorial Savings Bank and the Company are subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories.

ITEM 8. Financial Statements and Supplementary Data



Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of
Territorial Bancorp, Inc.

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Territorial Bancorp, Inc. and subsidiaries (the "Company") as of December 31, 2019 and 2018, the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control - Integrated Framework 2013* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2019 and 2018, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control - Integrated Framework 2013* issued by COSO.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and

testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

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

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

/s/ Moss Adams LLP

Portland, Oregon
March 13, 2020

We have served as the Company's auditor since 2015.

TERRITORIAL BANCORP INC. AND SUBSIDIARIES
Consolidated Balance Sheets
December 31, 2019 and 2018
(Dollars in thousands, except share data)

| | <u>December 31, 2019</u> | <u>December 31, 2018</u> |
|---|------------------------------|------------------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 44,806 | \$ 47,063 |
| Investment securities available for sale, at fair value | 8,628 | 2,560 |
| Investment securities held to maturity, at amortized cost (fair value of \$371,305 and \$364,922 at December 31, 2019 and December 31, 2018, respectively) | 363,883 | 371,517 |
| Loans held for sale | 470 | 309 |
| Loans receivable, net | 1,584,784 | 1,574,714 |
| Federal Home Loan Bank stock, at cost | 8,723 | 8,093 |
| Federal Reserve Bank stock, at cost | 3,128 | 3,114 |
| Accrued interest receivable | 5,409 | 5,274 |
| Premises and equipment, net | 4,370 | 4,823 |
| Right-of-use asset, net | 11,580 | — |
| Bank-owned life insurance | 45,113 | 45,066 |
| Deferred income tax assets, net | 2,619 | 4,136 |
| Prepaid expenses and other assets | 2,800 | 2,537 |
| Total assets | <u>\$ 2,086,313</u> | <u>\$ 2,069,206</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Deposits | \$ 1,631,933 | \$ 1,629,164 |
| Advances from the Federal Home Loan Bank | 156,000 | 142,200 |
| Securities sold under agreements to repurchase | 10,000 | 30,000 |
| Accounts payable and accrued expenses | 23,038 | 23,346 |
| Lease liability | 12,183 | — |
| Income taxes payable | 2,305 | 2,407 |
| Advance payments by borrowers for taxes and insurance | 6,964 | 7,010 |
| Total liabilities | <u>1,842,423</u> | <u>1,834,127</u> |
| Stockholders' Equity: | | |
| Preferred stock, \$0.01 par value; authorized 50,000,000 shares, no shares issued or outstanding | — | — |
| Common stock, \$0.01 par value; authorized 100,000,000 shares; issued and outstanding 9,681,493 and 9,645,955 shares at December 31, 2019 and December 31, 2018, respectively | 97 | 97 |
| Additional paid-in capital | 65,057 | 65,090 |
| Unearned ESOP shares | (4,404) | (4,893) |
| Retained earnings | 190,808 | 182,594 |
| Accumulated other comprehensive loss | (7,668) | (7,809) |
| Total stockholders' equity | <u>243,890</u> | <u>235,079</u> |
| Total liabilities and stockholders' equity | <u>\$ 2,086,313</u> | <u>\$ 2,069,206</u> |

See accompanying Notes to Consolidated Financial Statements.

TERRITORIAL BANCORP INC. AND SUBSIDIARIES
Consolidated Statements of Income
For the years ended December 31, 2019 and 2018
(Dollars in thousands, except per share data)

| | 2019 | 2018 |
|---|------------------|------------------|
| Interest income: | | |
| Loans | \$ 63,137 | \$ 60,279 |
| Investment securities | 11,459 | 12,236 |
| Other investments | 972 | 786 |
| Total interest income | <u>75,568</u> | <u>73,301</u> |
| Interest expense: | | |
| Deposits | 13,463 | 11,015 |
| Advances from the Federal Home Loan Bank | 3,346 | 2,010 |
| Securities sold under agreements to repurchase | 218 | 504 |
| Total interest expense | <u>17,027</u> | <u>13,529</u> |
| Net interest income | 58,541 | 59,772 |
| Provision for loan losses | <u>61</u> | <u>119</u> |
| Net interest income after provision for loan losses | <u>58,480</u> | <u>59,653</u> |
| Noninterest income: | | |
| Service fees on loan and deposit accounts | 1,937 | 1,886 |
| Income on bank-owned life insurance | 835 | 865 |
| Gain on sale of investment securities | 2,910 | 45 |
| Gain on sale of loans | 1,540 | 72 |
| Other | 610 | 296 |
| Total noninterest income | <u>7,832</u> | <u>3,164</u> |
| Noninterest expense: | | |
| Salaries and employee benefits | 22,580 | 22,159 |
| Occupancy | 6,400 | 6,324 |
| Equipment | 4,183 | 3,980 |
| Federal deposit insurance premiums | 288 | 608 |
| Other general and administrative expenses | 4,555 | 4,423 |
| Total noninterest expense | <u>38,006</u> | <u>37,494</u> |
| Income before income taxes | 28,306 | 25,323 |
| Income taxes | <u>6,311</u> | <u>6,111</u> |
| Net income | <u>\$ 21,995</u> | <u>\$ 19,212</u> |
| Basic earnings per share | \$ 2.38 | \$ 2.07 |
| Diluted earnings per share | \$ 2.34 | \$ 2.03 |
| Cash dividends declared per common share | \$ 1.49 | \$ 1.14 |
| Basic weighted-average shares outstanding | 9,196,674 | 9,219,123 |
| Diluted weighted-average shares outstanding | 9,325,614 | 9,400,395 |

See accompanying Notes to Consolidated Financial Statements.

TERRITORIAL BANCORP INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
For the years ended December 31, 2019 and 2018
(Dollars in thousands)

| | <u>2019</u> | <u>2018</u> |
|---|------------------|------------------|
| Net income | \$ 21,995 | \$ 19,212 |
| Change in unfunded pension liability, net of tax | (457) | (938) |
| Change in unrealized gain or loss on securities, net of tax | 598 | (42) |
| Other comprehensive income (loss), net of tax | 141 | (980) |
| Comprehensive income | <u>\$ 22,136</u> | <u>\$ 18,232</u> |

See accompanying Notes to Consolidated Financial Statements.

TERRITORIAL BANCORP INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the years ended December 31, 2019 and 2018
(Dollars in thousands, except share data)

| | Common Shares Outstanding | Common Stock | Additional Paid-in Capital | Unearned ESOP Shares | Retained Earnings | Accumulated Other Comprehensive Loss | Total Stockholders' Equity |
|---|---------------------------------|-----------------|----------------------------------|----------------------------|----------------------|---|----------------------------------|
| Balances at December 31, 2017 | 9,915,058 | \$ 99 | \$ 73,050 | \$ (5,383) | \$ 172,782 | \$ (5,694) | \$ 234,854 |
| Net income | — | — | — | — | 19,212 | — | 19,212 |
| Other comprehensive loss | — | — | — | — | — | (980) | (980) |
| Reclassification of deferred taxes | — | — | — | — | 1,135 | (1,135) | — |
| Cash dividends declared (\$1.14 per share) | — | — | — | — | (10,535) | — | (10,535) |
| Share-based compensation | 4,401 | — | 341 | — | — | — | 341 |
| Allocation of 48,932 ESOP shares | — | — | 966 | 490 | — | — | 1,456 |
| Repurchase shares of common stock | (347,393) | (3) | (10,549) | — | — | — | (10,552) |
| Exercise of options for common stock | 73,889 | 1 | 1,282 | — | — | — | 1,283 |
| Balances at December 31, 2018 | 9,645,955 | \$ 97 | \$ 65,090 | \$ (4,893) | \$ 182,594 | \$ (7,809) | \$ 235,079 |
| Net income | — | — | — | — | 21,995 | — | 21,995 |
| Other comprehensive income | — | — | — | — | — | 141 | 141 |
| Adoption of lease accounting standard | — | — | — | — | (10) | — | (10) |
| Cash dividends declared (\$1.49 per share) | — | — | — | — | (13,771) | — | (13,771) |
| Share-based compensation | 6,541 | — | 571 | — | — | — | 571 |
| Allocation of 48,932 ESOP shares | — | — | 909 | 489 | — | — | 1,398 |
| Repurchase of shares of common stock | (192,248) | (2) | (5,384) | — | — | — | (5,386) |
| Exercise of options for common stock | 221,245 | 2 | 3,871 | — | — | — | 3,873 |
| Balances at December 31, 2019 | 9,681,493 | \$ 97 | \$ 65,057 | \$ (4,404) | \$ 190,808 | \$ (7,668) | \$ 243,890 |

See accompanying Notes to Consolidated Financial Statements.

TERRITORIAL BANCORP INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the years ended December 31, 2019 and 2018
(Dollars in thousands)

| | 2019 | 2018 |
|--|-----------|-----------|
| Cash flows from operating activities: | | |
| Net income | \$ 21,995 | \$ 19,212 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Provision for loan losses | 61 | 119 |
| Depreciation and amortization | 1,171 | 1,255 |
| Deferred income tax expense | 1,466 | 829 |
| Amortization of fees, discounts, and premiums, net | (493) | (469) |
| Amortization of right-of-use asset | 2,761 | — |
| Origination of loans held for sale | (7,982) | (9,912) |
| Proceeds from sales of loans held for sale | 10,133 | 10,078 |
| Gain on sale of loans, net | (1,540) | (72) |
| Net gain on sale of real estate owned | — | (4) |
| Gain on sale of investment securities available for sale | (153) | — |
| Gain on sale of investment securities held to maturity | (2,757) | (45) |
| Net loss on disposal of premises and equipment | — | 6 |
| ESOP expense | 1,398 | 1,456 |
| Share-based compensation expense | 571 | 341 |
| Increase in accrued interest receivable | (135) | (132) |
| Net increase in bank-owned life insurance | (835) | (865) |
| Net decrease in prepaid expenses and other assets | 81 | 1,315 |
| Net decrease in accounts payable and accrued expenses | (629) | (4,367) |
| Net decrease in lease liability | (2,638) | — |
| Net (decrease) increase in advance payments by borrowers for taxes and insurance | (46) | 386 |
| Net decrease in income taxes receivable | — | 1,571 |
| Net (decrease) increase in income taxes payable | (102) | 924 |
| Net cash from operating activities | 22,327 | 21,626 |
| Cash flows from investing activities: | | |
| Purchases of investment securities held to maturity | (9,210) | (14,983) |
| Principal repayments on investment securities held to maturity | 42,698 | 43,959 |
| Principal repayments on investment securities available for sale | 1,187 | 224 |
| Proceeds from sale of investment securities held to maturity | 3,527 | 4,462 |
| Proceeds from sale of investment securities available for sale | 5,117 | — |
| Loan originations, net of principal repayments on loans receivable | (48,782) | (85,547) |
| Purchases of Federal Home Loan Bank stock | (22,366) | (9,180) |
| Proceeds from redemption of Federal Home Loan Bank stock | 21,736 | 7,628 |
| Purchases of Federal Reserve Bank stock | (14) | (11) |
| Proceeds from bank-owned life insurance | 788 | — |
| Proceeds from sale of real estate owned | — | 50 |
| Purchases of premises and equipment | (718) | (363) |
| Net cash from investing activities | (6,037) | (53,761) |

(Continued)

TERRITORIAL BANCORP INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the years ended December 31, 2019 and 2018
(Dollars in thousands)

| | <u>2019</u> | <u>2018</u> |
|---|------------------|------------------|
| Cash flows from financing activities: | | |
| Net increase in deposits | \$ 2,769 | \$ 31,869 |
| Proceeds from advances from the Federal Home Loan Bank | 557,200 | 215,700 |
| Repayments of advances from the Federal Home Loan Bank | (543,400) | (180,700) |
| Proceeds from securities sold under agreements to repurchase | 5,000 | — |
| Repayments of securities sold under agreements to repurchase | (25,000) | — |
| Purchases of Fed Funds | 10 | 10 |
| Sales of Fed Funds | (10) | (10) |
| Proceeds from issuance of common stock | 170 | — |
| Repurchases of common stock | (1,597) | (9,270) |
| Cash dividends paid | (13,689) | (10,490) |
| | <u>(18,547)</u> | <u>47,109</u> |
| Net (decrease) increase in cash and cash equivalents | (2,257) | 14,974 |
| Cash and cash equivalents at beginning of the period | <u>47,063</u> | <u>32,089</u> |
| Cash and cash equivalents at end of the period | <u>\$ 44,806</u> | <u>\$ 47,063</u> |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for: | | |
| Interest on deposits and borrowings | \$ 16,873 | \$ 13,862 |
| Income taxes | 4,947 | 2,787 |
| Supplemental disclosure of noncash investing and financing activities: | | |
| Company stock acquired through stock swap and net settlement transactions | \$ 3,703 | \$ 1,282 |
| Company stock repurchased through stock swap and net settlement transactions | 3,789 | 1,282 |
| Loans transferred to real estate owned | — | 46 |
| Loans securitized into investment securities | 36,826 | — |
| Dividends declared, not yet paid | 82 | 45 |
| Establishment of right-of-use asset | 14,341 | — |
| Establishment of lease liability | 14,821 | — |
| Transfer of securities from held-to-maturity to available-for-sale | 11,390 | — |

See accompanying Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

(1) Organization

In 2009, Territorial Savings Bank completed a conversion from a mutual holding company to a stock holding company and Territorial Bancorp Inc. became the holding company for Territorial Savings Bank. Upon completion of the conversion and reorganization, a special “liquidation account” was established in an amount equal to the total equity of Territorial Mutual Holding Company as of December 31, 2008. The liquidation account is to provide eligible account holders and supplemental eligible account holders who maintain their deposit accounts with Territorial Savings Bank after the conversion with a liquidation interest in the unlikely event of the complete liquidation of Territorial Savings Bank after the conversion.

In 2014, Territorial Savings Bank converted from a federal savings bank to a Hawaii state-chartered savings bank and became a member of the Federal Reserve System.

(2) Summary of Significant Accounting Policies

(a) Description of Business

Territorial Bancorp Inc. (the Company), through its wholly-owned subsidiary, Territorial Savings Bank (the Bank), provides loan and deposit products and services primarily to individual customers through 29 branches located throughout Hawaii. We deal primarily in residential mortgage loans in the State of Hawaii. The Company’s earnings depend primarily on its net interest income, which is the difference between the interest income earned on interest-earning assets (loans receivable and investments) and the interest expense incurred on interest-bearing liabilities (deposit liabilities and borrowings). Deposits traditionally have been the principal source of the Bank’s funds for use in lending, meeting liquidity requirements, and making investments. The Company also derives funds from receipt of interest and principal repayments on outstanding loans receivable and investments, borrowings from the Federal Home Loan Bank (FHLB), securities sold under agreements to repurchase, and proceeds from issuance of common stock.

(b) Principles of Consolidation

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

(c) Cash and Cash Equivalents

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

(d) Investment Securities

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

At December 31, 2019 and 2018, the Company classified all of its investments, except \$8.6 million and \$2.6 million of securities, respectively, as held-to-maturity.

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

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

(e) Loans Receivable

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

(f) Loans Held for Sale

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

(g) Deferred Loan Origination Fees and Unearned Loan Discounts

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

(h) Real Estate Owned

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

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

(i) Allowance for Loan Losses

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

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

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

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

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

The Company also uses historical loss rates adjusted for qualitative and environmental factors to establish loan loss allowances for the following portfolio segments:

- home equity loans and lines of credit; and
- consumer and other loans.

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

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

While the Company uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, the bank regulators will periodically review the allowance for loan losses. The bank regulators may require the Company to increase the allowance based on their analysis of information available at the time of their examination.

(j) Transfer of Financial Assets

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

Mortgage loans may also be packaged into securities that are issued and guaranteed by U.S. government-sponsored enterprises or a U.S. government agency. The Company receives 100% of the mortgage-backed securities issued. The mortgage-backed securities received in securitizations are valued at fair value and classified as held-to-maturity. A gain or loss in the securitization transactions is recognized for the difference between the fair value of the mortgage-backed securities received and the amortized cost of the loans securitized.

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

(k) Premises and Equipment

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

(l) Income Taxes

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

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

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

As of December 31, 2019 and 2018, the Company had not recognized a liability for income tax uncertainties in the accompanying Consolidated Balance Sheets because management concluded that the Company does not have uncertain tax positions.

The Company recognizes interest and penalties related to tax liabilities in other interest expense and other general and administrative expenses, respectively, in the Consolidated Statements of Income.

Tax years 2016 to 2018 currently remain subject to examination by the Internal Revenue Service and by the Department of Taxation of the State of Hawaii.

(m) Impairment of Long-Lived Assets

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

(n) Pension Plan

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

(o) Share-Based Compensation

The Company grants share-based compensation awards, including restricted stock and restricted stock units, which are either performance-based or time-based. The fair value of the restricted stock and restricted stock unit awards were based on the closing price of the Company's stock on the date of grant. The cost of these awards are amortized in the Consolidated Statements of Income on a straight-line basis over the vesting period. The amount of performance-based restricted stock units that vest on a performance condition is remeasured quarterly based on how the Company's return on average equity compares to the SNL Bank Index. The fair value of performance-based restricted stock units that are based on how the Company's total stock return compares to the SNL Bank Index was measured using a Monte-Carlo valuation.

(p) Supplemental Employee Retirement Plan (SERP)

The SERP is a noncontributory supplemental retirement plan covering certain current and former employees of the Company. Benefits in the SERP plan are paid after retirement, in addition to the benefits provided by the Pension Plan. The Company accrues SERP costs over the estimated period until retirement by charging salaries and employee benefits expense in the Consolidated Statements of Income, with a corresponding credit to accounts payable and accrued expenses in the Consolidated Balance Sheets.

(q) Employee Stock Ownership Plan (ESOP)

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

(r) Earnings Per Share

We have two forms of our outstanding common stock: common stock and unvested restricted stock awards. Holders of unvested restricted stock awards receive non-forfeitable dividends at the same rate as common shareholders and they both share equally in undistributed earnings. Unvested restricted stock awards that contain nonforfeitable rights to dividends or dividend equivalents are considered to be participating securities in the earnings per share computation using the two-class method. Under the two-class method, earnings are allocated to common shareholders and participating securities according to their respective rights to earnings.

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

(s) Common Stock Repurchase Program

The Company adopted common stock repurchase programs in which shares repurchased reduce the amount of shares issued and outstanding. The repurchased shares may be reissued in connection with share-based compensation plans and for general corporate purposes. During 2019 and 2018, the Company repurchased 59,700 and 303,500 shares of common stock, respectively, at an average cost of \$26.74 and \$30.36, respectively, as part of the repurchase programs authorized by the Board of Directors.

(t) Bank-Owned Life Insurance

The Company's investment in bank-owned life insurance is based on cash surrender value. The Company invests in bank-owned life insurance to provide a funding source for benefit plan obligations. Bank-owned

life insurance also generally provides noninterest income that is nontaxable. Federal regulations generally limit the investment in bank-owned life insurance to 25% of the Bank's Tier 1 capital plus the allowance for loan losses. At December 31, 2019, this limit was \$57.6 million and the Company had invested \$45.1 million in bank-owned life insurance at that date.

(u) Leases

The Company leases most of its premises and some vehicles and equipment under operating leases expiring on various dates through 2029. The majority of lease agreements relate to real estate and generally provide that the Company pay taxes, insurance, maintenance and certain other operating expenses applicable to the leased premises. Variable lease components and nonlease components are not included in the Company's computation of the right-of-use (ROU) asset or lease liability. The Company also does not include short-term leases in the computation of the ROU asset or lease liability. Short-term leases are leases with a term at commencement of 12 months or less. Short-term lease expense is recorded on a straight-line basis over the term of the lease. Lease agreements do not contain any residual value guarantees or restrictive covenants.

Certain leases have renewal options at the expiration of the lease terms. Generally, option periods are not included in the computation of the lease term, ROU asset or lease liability because the Company is not reasonably certain to exercise renewal options at the expiration of the lease terms. The Company has elected to use the package of practical expedients to: a) not reassess whether any expired or existing contracts are or contain leases, b) not reassess the lease classification for any expired or existing leases, and c) not reassess initial direct costs for any existing leases. The Company has also chosen the option to not restate comparative periods prior to the adoption of the new lease accounting standard.

Because the discount rates implicit in our leases are not known, discount rates have been estimated using the rates for fixed-rate, amortizing advances from the Federal Home Loan Bank (FHLB) for the approximate terms of the leases.

(v) Use of Estimates

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

(w) Recently Issued Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board (FASB) amended the Leases topic of the FASB Accounting Standards Codification (ASC). The primary effects of the amendment are to recognize lease assets and lease liabilities on the balance sheet and to disclose certain information about leasing arrangements. The amendment is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company has several lease agreements for branch locations and equipment that require recognition on the Consolidated Balance Sheets upon adoption of the amendment. The Company adopted this amendment as of January 1, 2019 by recording a right-of-use asset of \$12.7 million and a lease liability of \$13.2 million.

In June 2016, the FASB amended various sections of the FASB ASC related to the accounting for credit losses on financial instruments. The amendment changes the threshold for recognizing losses from a "probable" to an "expected" model. The new model is referred to as the current expected credit loss model and applies to loans, leases, held-to-maturity investments, loan commitments and financial guarantees.

The amendment requires the measurement of all expected credit losses for financial assets as of the reporting date (including historical experience, current conditions and reasonable and supportable forecasts) and enhanced disclosures that will help financial statement users understand the estimates and judgments used in estimating credit losses and evaluating the credit quality of an organization's portfolio. The amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. In November 2019, the FASB issued an update that delays the effective date of the amendment for smaller reporting companies, as defined by the Securities and Exchange Commission, to fiscal years beginning after December 15, 2022. The Company is a smaller reporting company. The Company will apply the amendment's provisions as a cumulative-effect adjustment to retained earnings at the beginning of the first period the amendment is effective. The Company is currently evaluating the effects that the adoption of this amendment will have on its Consolidated Financial Statements by gathering the information that is necessary to make the calculations required by the amendment. This may result in increased credit losses on financial instruments recorded in the Consolidated Financial Statements.

In August 2017, the FASB amended the Derivatives and Hedging topic of the FASB ASC. The primary focus of the amendment is to simplify hedge accounting and make the results of hedge transactions in the financial statements easier to understand. An ancillary result of the amendment is that an entity may make a one-time transfer of certain securities from the held-to-maturity classification to the available-for-sale classification. The amendment is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company does not engage in hedging activities. However, at January 1, 2019, it elected to transfer \$11.4 million of held-to-maturity securities to the available-for-sale classification and recorded an unrecognized gain of \$304,000, net of taxes, to other comprehensive income.

In August 2018, the FASB amended the Fair Value Measurement topic of the FASB ASC. The amendment affects disclosures only, and includes additions, deletions and modifications of the disclosures of assets and liabilities reported in the fair value hierarchy. The amendment is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted. Entities are allowed to early adopt any removed or modified disclosures while delaying adoption of any added disclosures until the effective date. The Company does not expect the adoption of this amendment to have a material effect on its Consolidated Financial Statements.

In August 2018, the FASB amended the Compensation – Retirement Benefits topic of the FASB ASC. The amendment affects disclosures related to defined benefit pension or other post retirement plans and includes additions, deletions and clarifications of disclosures. The amendment is effective for fiscal years ending after December 15, 2020, with early adoption permitted. The Company does not expect the adoption of this amendment to have a material effect on its Consolidated Financial Statements.

(3) Cash and Cash Equivalents

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

| <u>(Dollars in thousands)</u> | <u>December 31,</u> | |
|--|---------------------|------------------|
| | <u>2019</u> | <u>2018</u> |
| Cash and due from banks | \$ 9,571 | \$ 9,771 |
| Interest-earning deposits in other banks | 35,235 | 37,292 |
| Cash and cash equivalents | <u>\$ 44,806</u> | <u>\$ 47,063</u> |

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

(4) Investment Securities

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

| (Dollars in thousands) | Amortized Cost | Gross Unrealized | | Estimated Fair Value |
|--|-------------------|------------------|-------------------|-------------------------|
| | | Gains | Losses | |
| December 31, 2019: | | | | |
| Available-for-sale: | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 7,905 | \$ 723 | \$ — | \$ 8,628 |
| Total | <u>\$ 7,905</u> | <u>\$ 723</u> | <u>\$ —</u> | <u>\$ 8,628</u> |
| Held-to-maturity: | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 363,883 | \$ 8,436 | \$ (1,014) | \$ 371,305 |
| Total | <u>\$ 363,883</u> | <u>\$ 8,436</u> | <u>\$ (1,014)</u> | <u>\$ 371,305</u> |
| December 31, 2018: | | | | |
| Available-for-sale: | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 2,644 | \$ — | \$ (84) | \$ 2,560 |
| Total | <u>\$ 2,644</u> | <u>\$ —</u> | <u>\$ (84)</u> | <u>\$ 2,560</u> |
| Held-to-maturity: | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 371,442 | \$ 2,056 | \$ (9,279) | \$ 364,219 |
| Trust preferred securities | 75 | 628 | — | 703 |
| Total | <u>\$ 371,517</u> | <u>\$ 2,684</u> | <u>\$ (9,279)</u> | <u>\$ 364,922</u> |

The amortized cost and estimated fair value of investment securities by maturity date at December 31, 2019 are shown below. Incorporated in the maturity schedule are mortgage-backed securities, which are allocated using the contractual maturity as a basis. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands) | Amortized Cost | Estimated Fair Value |
|------------------------------------|-------------------|-------------------------|
| Available-for-sale: | | |
| Due within 5 years | \$ — | \$ — |
| Due after 5 years through 10 years | — | — |
| Due after 10 years | 7,905 | 8,628 |
| Total | <u>\$ 7,905</u> | <u>\$ 8,628</u> |
| Held-to-maturity: | | |
| Due within 5 years | \$ — | \$ — |
| Due after 5 years through 10 years | 60 | 61 |
| Due after 10 years | 363,823 | 371,244 |
| Total | <u>\$ 363,883</u> | <u>\$ 371,305</u> |

Realized gains and losses and the proceeds from sales of held-to-maturity and available-for-sale securities are shown in the table below.

| (Dollars in thousands) | 2019 | 2018 |
|------------------------|----------|----------|
| Proceeds from sales | \$ 8,644 | \$ 4,462 |
| Gross gains | 2,910 | 45 |
| Gross losses | — | — |

During 2019, the Company sold its \$75,000 investment in its trust preferred security, PreTSL XXIII, and \$746,000 of held-to-maturity mortgage-backed securities, and recorded gains of \$2.7 million and \$40,000,

respectively. During 2018, the Company sold \$4.4 million of held-to-maturity securities and recorded a gain of \$45,000. The sale of the trust preferred security, which had a significant deterioration in the issuer's credit rating, and the sale of the mortgage-backed securities, for which the company had already collected a substantial portion of the outstanding purchased principal (at least 85%), were in accordance with the Investments – Debt and Equity Securities topic of the FASB ASC and do not taint management's assertion of its intent to hold remaining securities in the held-to-maturity portfolio to maturity.

During 2019, the Company sold \$5.0 million of available-for-sale mortgage-backed securities and recorded a gain of \$153,000. The Company did not sell any available-for-sale securities in 2018.

As of January 1, 2019, the Company transferred securities with an amortized cost of \$11.4 million from held-to-maturity to available-for-sale with the adoption of ASU 2017-12 on derivatives and hedging.

Investment securities with amortized costs of \$188.9 million and \$308.8 million at December 31, 2019 and 2018, respectively, were pledged to secure deposits made by state and local governments, securities sold under agreements to repurchase and transaction clearing accounts.

Provided below is a summary of investment securities which were in an unrealized loss position at December 31, 2019 and 2018. The Company does not intend to sell held-to-maturity and available-for-sale securities until such time as the value recovers or the securities mature and it is not more likely than not that the Company will be required to sell the securities prior to recovery of value or the securities mature.

| Description of securities (Dollars in thousands) | Less Than 12 Months | | 12 Months or Longer | | Number of Securities | Total | |
|--|---------------------|----------------------|---------------------|----------------------|-------------------------|------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | | Fair Value | Unrealized Losses |
| December 31, 2019: | | | | | | | |
| Held-to-maturity: | | | | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 55,882 | \$ (302) | \$ 34,492 | \$ (712) | 30 | \$ 90,374 | \$ (1,014) |
| December 31, 2018: | | | | | | | |
| Available-for-sale: | | | | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ — | \$ — | \$ 2,560 | \$ (84) | 1 | \$ 2,560 | \$ (84) |
| Held-to-maturity: | | | | | | | |
| U.S. government-sponsored mortgage-backed securities | \$ 57,154 | \$ (254) | \$ 220,338 | \$ (9,025) | 81 | \$ 277,492 | \$ (9,279) |

Mortgage-Backed Securities. The unrealized losses on the Company's investment in mortgage-backed securities were caused by increases in market interest rates subsequent to purchase. All of the mortgage-backed securities are guaranteed by Freddie Mac or Fannie Mae, which are U.S. government-sponsored enterprises, or Ginnie Mae, which is a U.S. government agency. Since the decline in market value is attributable to changes in interest rates and not credit quality, and the Company does not intend to sell these investments until maturity and it is not more likely than not that the Company will be required to sell such investments prior to recovery of its cost basis, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2019 and 2018.

During 2019, the Company securitized fixed-rate first mortgage loans with a book value of \$36.8 million into Freddie Mac mortgage-backed securities to increase liquidity. The securitization transactions increased investment securities and lowered loans receivable. The securitization transactions were accounted for by recording the mortgage-backed securities at a fair value of \$37.9 million in accordance with the FASB ASC. A net gain of \$1.5 million on the sale of loans was recognized on the securitization transactions as the fair value of the mortgage-backed securities exceeded the amortized cost of the mortgage loans.

(5) Federal Home Loan Bank Stock

The Bank, as a member of the FHLB system, is required to obtain and hold shares of capital stock in the FHLB. At December 31, 2019 and 2018, the Bank met such requirement. At December 31, 2019 and 2018, the Bank owned \$8.7 million and \$8.1 million, respectively, of capital stock of the FHLB Des Moines.

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

(6) Federal Reserve Bank Stock

The Bank, as a member of the Federal Reserve System, is required to hold shares of capital stock of the FRB of San Francisco equal to six percent of capital and surplus of the Bank. At December 31, 2019 and 2018, the Bank met such requirement. At December 31, 2019 and 2018, the Bank owned \$3.1 million of capital stock of the FRB of San Francisco.

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

(7) Loans Receivable and Allowance for Loan Losses

The components of loans receivable are as follows:

| (Dollars in thousands) | December 31, | |
|--|---------------------|---------------------|
| | 2019 | 2018 |
| Real estate loans: | | |
| First mortgages: | | |
| One- to four-family residential | \$ 1,536,781 | \$ 1,531,149 |
| Multi-family residential | 9,965 | 12,151 |
| Construction, commercial and other | 23,382 | 20,780 |
| Home equity loans and lines of credit | 10,084 | 11,090 |
| Total real estate loans | <u>1,580,212</u> | <u>1,575,170</u> |
| Other loans: | | |
| Loans on deposit accounts | 235 | 357 |
| Consumer and other loans | 9,484 | 4,939 |
| Total other loans | <u>9,719</u> | <u>5,296</u> |
| Less: | | |
| Net unearned fees and discounts | (2,435) | (3,110) |
| Allowance for loan losses | (2,712) | (2,642) |
| Total unearned fees, discounts and allowance for loan losses | <u>(5,147)</u> | <u>(5,752)</u> |
| Loans receivable, net | <u>\$ 1,584,784</u> | <u>\$ 1,574,714</u> |

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

| (Dollars in thousands) | Residential Mortgage | Construction, Commercial and Other Mortgage Loans | Home Equity Loans and Lines of Credit | Consumer and Other | Unallocated | Totals |
|---|-------------------------|---|---|-----------------------|---------------|-----------------|
| Year ended December 31, 2019: | | | | | | |
| Balance, beginning of year | \$ 1,797 | \$ 443 | \$ 1 | \$ 47 | \$ 354 | \$ 2,642 |
| Provision (reversal of provision) for loan losses | (84) | 68 | — | 26 | 51 | 61 |
| | <u>1,713</u> | <u>511</u> | <u>1</u> | <u>73</u> | <u>405</u> | <u>2,703</u> |
| Charge-offs | (8) | — | — | (40) | — | (48) |
| Recoveries | 36 | — | — | 21 | — | 57 |
| Net recoveries (charge-offs) | 28 | — | — | (19) | — | 9 |
| Balance, end of year | <u>\$ 1,741</u> | <u>\$ 511</u> | <u>\$ 1</u> | <u>\$ 54</u> | <u>\$ 405</u> | <u>\$ 2,712</u> |
| Year ended December 31, 2018: | | | | | | |
| Balance, beginning of year | \$ 1,721 | \$ 539 | \$ 1 | \$ 55 | \$ 232 | \$ 2,548 |
| Provision (reversal of provision) for loan losses | 78 | (96) | — | 15 | 122 | 119 |
| | <u>1,799</u> | <u>443</u> | <u>1</u> | <u>70</u> | <u>354</u> | <u>2,667</u> |
| Charge-offs | (12) | — | — | (29) | — | (41) |
| Recoveries | 10 | — | — | 6 | — | 16 |
| Net charge-offs | (2) | — | — | (23) | — | (25) |
| Balance, end of year | <u>\$ 1,797</u> | <u>\$ 443</u> | <u>\$ 1</u> | <u>\$ 47</u> | <u>\$ 354</u> | <u>\$ 2,642</u> |

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

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

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

Management considers the allowance for loan losses at December 31, 2019 to be at an appropriate level to provide for probable losses that can be reasonably estimated based on general and specific conditions at that date. While the Company uses the best information it has available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. To the extent actual outcomes differ from the estimates, additional provisions for credit losses may be required that would reduce future earnings. In addition, as an integral part of their examination process, the bank regulators periodically review the allowance for loan losses and may require the Company to increase the allowance based on their analysis of information available at the time of their examination.

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

| (Dollars in thousands) | Residential Mortgage | Construction, Commercial and Other Mortgage Loans | Home Equity Loans and Lines of Credit | Consumer and Other | Unallocated | Totals |
|---------------------------------------|---------------------------------|--|--|-------------------------------|--------------------|---------------------|
| December 31, 2019: | | | | | | |
| Allowance for loan losses: | | | | | | |
| Ending allowance balance: | | | | | | |
| Individually evaluated for impairment | \$ — | \$ — | \$ — | \$ — | \$ — | \$ — |
| Collectively evaluated for impairment | 1,741 | 511 | 1 | 54 | 405 | 2,712 |
| Total ending allowance balance | <u>\$ 1,741</u> | <u>\$ 511</u> | <u>\$ 1</u> | <u>\$ 54</u> | <u>\$ 405</u> | <u>\$ 2,712</u> |
| Loans: | | | | | | |
| Ending loan balance: | | | | | | |
| Individually evaluated for impairment | \$ 1,224 | \$ — | \$ 89 | \$ — | \$ — | \$ 1,313 |
| Collectively evaluated for impairment | 1,543,125 | 23,326 | 9,997 | 9,735 | — | 1,586,183 |
| Total ending loan balance | <u>\$ 1,544,349</u> | <u>\$ 23,326</u> | <u>\$ 10,086</u> | <u>\$ 9,735</u> | <u>\$ —</u> | <u>\$ 1,587,496</u> |
| December 31, 2018: | | | | | | |
| Allowance for loan losses: | | | | | | |
| Ending allowance balance: | | | | | | |
| Individually evaluated for impairment | \$ — | \$ — | \$ — | \$ — | \$ — | \$ — |
| Collectively evaluated for impairment | 1,797 | 443 | 1 | 47 | 354 | 2,642 |
| Total ending allowance balance | <u>\$ 1,797</u> | <u>\$ 443</u> | <u>\$ 1</u> | <u>\$ 47</u> | <u>\$ 354</u> | <u>\$ 2,642</u> |
| Loans: | | | | | | |
| Ending loan balance: | | | | | | |
| Individually evaluated for impairment | \$ 2,962 | \$ — | \$ 148 | \$ — | \$ — | \$ 3,110 |
| Collectively evaluated for impairment | 1,537,292 | 20,698 | 10,945 | 5,311 | — | 1,574,246 |
| Total ending loan balance | <u>\$ 1,540,254</u> | <u>\$ 20,698</u> | <u>\$ 11,093</u> | <u>\$ 5,311</u> | <u>\$ —</u> | <u>\$ 1,577,356</u> |

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

| (Dollars in thousands) | Recorded Investment | Unpaid Principal Balance |
|---|--------------------------------|---|
| December 31, 2019: | | |
| With no related allowance recorded: | | |
| One- to four-family residential mortgages | \$ 1,224 | \$ 1,615 |
| Home equity loans and lines of credit | 89 | 178 |
| Total | <u>\$ 1,313</u> | <u>\$ 1,793</u> |
| December 31, 2018: | | |
| With no related allowance recorded: | | |
| One- to four-family residential mortgages | \$ 2,962 | \$ 3,486 |
| Home equity loans and lines of credit | 148 | 224 |
| Total | <u>\$ 3,110</u> | <u>\$ 3,710</u> |

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

| (Dollars in thousands) | Average Recorded Investment | Interest Income Recognized |
|---|-----------------------------------|-------------------------------|
| 2019: | | |
| With no related allowance recorded: | | |
| One- to four-family residential mortgages | \$ 1,272 | \$ 34 |
| Home equity loans and lines of credit | 98 | — |
| Total | <u>\$ 1,370</u> | <u>\$ 34</u> |
| 2018: | | |
| With no related allowance recorded: | | |
| One- to four-family residential mortgages | \$ 3,039 | \$ 53 |
| Home equity loans and lines of credit | 156 | — |
| Total | <u>\$ 3,195</u> | <u>\$ 53</u> |

There were no loans individually evaluated for impairment with a related allowance for loan loss as of December 31, 2019 or 2018. Loans individually evaluated for impairment do not have an allocated allowance for loan loss because they are written down to fair value at the time of impairment.

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

| (Dollars in thousands) | 30 - 59 Days Past Due | 60 - 89 Days Past Due | 90 Days or More Past Due | Total Past Due | Loans Not Past Due | Total Loans | Nonaccrual Loans | Loans 90 Days or More Past Due and Still Accruing |
|--|--------------------------|--------------------------|--------------------------------|-------------------|-----------------------|---------------------|---------------------|--|
| December 31, 2019: | | | | | | | | |
| One- to four-family residential mortgages | \$ — | \$ 959 | \$ — | \$ 959 | \$ 1,533,446 | \$ 1,534,405 | \$ 647 | \$ — |
| Multi-family residential mortgages | — | — | — | — | 9,944 | 9,944 | — | — |
| Construction, commercial and other mortgages | — | — | — | — | 23,326 | 23,326 | — | — |
| Home equity loans and lines of credit | — | 26 | — | 26 | 10,060 | 10,086 | 89 | — |
| Loans on deposit accounts | — | — | — | — | 235 | 235 | — | — |
| Consumer and other | 33 | 1 | 1 | 35 | 9,465 | 9,500 | — | 1 |
| Total | <u>\$ 33</u> | <u>\$ 986</u> | <u>\$ 1</u> | <u>\$ 1,020</u> | <u>\$ 1,586,476</u> | <u>\$ 1,587,496</u> | <u>\$ 736</u> | <u>\$ 1</u> |
| December 31, 2018: | | | | | | | | |
| One- to four-family residential mortgages | \$ 40 | \$ 292 | \$ 838 | \$ 1,170 | \$ 1,526,949 | \$ 1,528,119 | \$ 2,065 | \$ — |
| Multi-family residential mortgages | — | — | — | — | 12,135 | 12,135 | — | — |
| Construction, commercial and other mortgages | — | — | — | — | 20,698 | 20,698 | — | — |
| Home equity loans and lines of credit | — | 29 | 41 | 70 | 11,023 | 11,093 | 148 | — |
| Loans on deposit accounts | — | — | — | — | 357 | 357 | — | — |
| Consumer and other | 3 | 4 | — | 7 | 4,947 | 4,954 | — | — |
| Total | <u>\$ 43</u> | <u>\$ 325</u> | <u>\$ 879</u> | <u>\$ 1,247</u> | <u>\$ 1,576,109</u> | <u>\$ 1,577,356</u> | <u>\$ 2,213</u> | <u>\$ —</u> |

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

The Company had six nonaccrual loans with a book value of \$736,000 at December 31, 2019 and 11 nonaccrual loans with a book value of \$2.2 million as of December 31, 2018. The Company collected interest on nonaccrual loans of \$58,000 and \$93,000 during 2019 and 2018, respectively, but due to regulatory requirements, the Company recorded the interest as a reduction of principal. The Company would have recognized additional interest income of \$60,000 and \$133,000 during 2019 and 2018, respectively, had the loans been accruing interest. At December 31, 2019, the Company had one loan for \$1,000 that was 90 days or more past due and still accruing interest. The Company did not have any loans 90 days or more past due and still accruing interest as of December 31, 2018.

There were no loans modified in a troubled debt restructuring during the year ended December 31, 2019 or 2018. There were no new troubled debt restructurings within the 12 months ended December 31, 2019 that subsequently defaulted.

The table below summarizes troubled debt restructurings by class of loans:

| (Dollars in thousands) | Number of Loans | Accrual Status | Number of Loans | Nonaccrual Status | Total |
|---|--------------------|-------------------|--------------------|----------------------|-----------------|
| December 31, 2019: | | | | | |
| One- to four-family residential mortgages | 3 | \$ 577 | 2 | \$ 525 | \$ 1,102 |
| Home equity loans and lines of credit | — | — | 1 | 64 | 64 |
| Total | <u>3</u> | <u>\$ 577</u> | <u>3</u> | <u>\$ 589</u> | <u>\$ 1,166</u> |
| December 31, 2018: | | | | | |
| One- to four-family residential mortgages | 4 | \$ 897 | 3 | \$ 691 | \$ 1,588 |
| Home equity loans and lines of credit | — | — | 1 | 78 | 78 |
| Total | <u>4</u> | <u>\$ 897</u> | <u>4</u> | <u>\$ 769</u> | <u>\$ 1,666</u> |

There were no delinquent restructured loans at December 31, 2019 or December 31, 2018. Restructurings include deferrals of interest and/or principal payments and temporary or permanent reductions in interest rates due to the financial difficulties of the borrowers. At December 31, 2019, we have no commitments to lend any additional funds to these borrowers.

The Company had no real estate owned as of December 31, 2019 or 2018. There were no loans in the process of foreclosure at December 31, 2019. There were two one- to four-family residential mortgage loans totaling \$838,000 and one home equity loan for \$41,000 in the process of foreclosure as of December 31, 2018.

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

During the years ended December 31, 2019 and 2018, the Company sold mortgage loans held for sale with principal balances of \$10.1 million and \$10.0 million, respectively, and recognized gains of \$89,000 and \$72,000, respectively. The Company had one loan held for sale for \$470,000 at December 31, 2019 and one loan held for sale for \$309,000 at December 31, 2018.

During 2019, the Company securitized fixed-rate first mortgage loans with a book value of \$36.8 million and received mortgage-backed securities with a fair market value of \$37.9 million. The Company retained the servicing of these loans and recorded mortgage servicing assets with a fair market value of \$344,000. A net gain of \$1.5 million was recognized on the securitization transactions as the fair value of the mortgage-backed securities exceeded the amortized cost of the mortgage loans.

The Company serviced loans for others with principal balances of \$65.1 million and \$30.3 million at December 31, 2019 and 2018, respectively. Of these amounts, \$37.8 million and \$1.5 million of loan balances relate to securitizations for which the Company continues to hold the related mortgage-backed securities at December 31, 2019 and 2018, respectively. The amount of contractually specified servicing fees earned was \$114,000 and

\$88,000 for 2019 and 2018, respectively. The fees are reported in service fees on loan and deposit accounts in the Consolidated Statements of Income.

In the normal course of business, the Company has made loans to certain directors and executive officers under terms which management believes are consistent with the Company's general lending policies. Loans to directors and executive officers amounted to \$661,000 at December 31, 2019 and \$850,000 at December 31, 2018.

(8) Accrued Interest Receivable

The components of accrued interest receivable are as follows:

| (Dollars in thousands) | December 31, | |
|---------------------------|-----------------|-----------------|
| | 2019 | 2018 |
| Loans receivable | \$ 4,425 | \$ 4,302 |
| Investment securities | 952 | 960 |
| Interest-bearing deposits | 32 | 12 |
| Total | <u>\$ 5,409</u> | <u>\$ 5,274</u> |

(9) Mortgage Servicing Assets

Mortgage servicing assets are created when the Company sells mortgage loans and retains the rights to service the loans. Mortgage servicing assets are accounted for in accordance with the Transfers and Servicing topic of the FASB ASC and are initially valued at fair value and subsequently at the lower of cost or fair value. We amortize mortgage servicing assets in proportion to and over the period of estimated net servicing income. All servicing assets are grouped into categories based on the interest rate and original term of the loan sold. Mortgage servicing assets related to loan sales are recorded as a gain on sale of loans and totaled \$344,000 and \$0 for the years ended December 31, 2019 and 2018, respectively.

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

| (Dollars in thousands) | 2019 | 2018 |
|------------------------------|---------------|---------------|
| Balance at beginning of year | \$ 226 | \$ 263 |
| Additions | 344 | — |
| Impairments | (16) | — |
| Amortization | (51) | (37) |
| Balance at end of year | <u>\$ 503</u> | <u>\$ 226</u> |

The Company added \$344,000 in mortgage servicing assets when it securitized \$36.8 million of mortgage loans into mortgage-backed securities and sold \$2.2 million of mortgage loans on a servicing retained basis. These transactions were conducted to increase liquidity.

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

| (Dollars in thousands) | December 31, | |
|--------------------------|---------------|---------------|
| | 2019 | 2018 |
| Gross carrying value | \$ 1,638 | \$ 1,310 |
| Accumulated amortization | (1,135) | (1,084) |
| Net carrying value | <u>\$ 503</u> | <u>\$ 226</u> |

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

| (Dollars in thousands) | |
|-------------------------------|---------------|
| 2020 | \$ 92 |
| 2021 | 73 |
| 2022 | 57 |
| 2023 | 46 |
| 2024 | 38 |
| Thereafter | 197 |
| Total | <u>\$ 503</u> |

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

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

The table below presents the fair values and key assumptions used in determining the fair values of our mortgage servicing assets as of December 31, 2019 and 2018:

| | <u>2019</u> | <u>2018</u> |
|--|-------------|-------------|
| Fair value, beginning of year (in thousands) | \$ 291 | \$ 311 |
| Fair value, end of year (in thousands) | 552 | 291 |
| Weighted average discount rate | 10.25 % | 10.50 % |
| Weighted average prepayment speed assumption (CPR) | 12.58 | 8.86 |
| Annual cost to service (per loan) | \$ 75 | \$ 70 |

The conditional prepayment rate (CPR) prepayment model assumes constant prepayment rates each period.

(10) Interest Rate Lock and Forward Loan Sale Commitments

The Company may enter into interest rate lock commitments with borrowers on loans intended to be sold. To manage interest rate risk on the lock commitments, the Company may also enter into forward loan sale commitments. The interest rate lock commitments and forward loan sale commitments are treated as derivatives and are recorded at their fair values in prepaid expenses and other assets or in accounts payable and accrued expenses. Changes in fair value are recorded in current earnings. At December 31, 2019, interest rate locks and forward loan sale commitments on loans held for sale amounted to \$1.8 million and \$2.2 million, respectively.

The table below presents the location of assets and liabilities related to derivatives:

| (Dollars in thousands) | Location on Balance Sheet | Asset Derivatives | | Liability Derivatives | |
|-------------------------|---------------------------------------|----------------------------|-------------|----------------------------|-------------|
| | | Fair Value at December 31, | | Fair Value at December 31, | |
| | | 2019 | 2018 | 2019 | 2018 |
| Interest rate contracts | Prepaid expenses and other assets | \$ 5 | \$ 5 | \$ — | \$ — |
| Interest rate contracts | Accounts payable and accrued expenses | — | — | 5 | 5 |
| Total derivatives | | <u>\$ 5</u> | <u>\$ 5</u> | <u>\$ 5</u> | <u>\$ 5</u> |

There were no gains or losses on derivatives for the years ended December 31, 2019 and 2018.

(11) Premises and Equipment

Premises and equipment are as follows:

| (Dollars in thousands) | December 31, | |
|--|-----------------|-----------------|
| | 2019 | 2018 |
| Land | \$ 585 | \$ 585 |
| Buildings and improvements | 1,365 | 1,365 |
| Leasehold improvements | 14,027 | 13,938 |
| Furniture, fixtures and equipment | 6,035 | 5,502 |
| Automobiles | 115 | 115 |
| | 22,127 | 21,505 |
| Less accumulated depreciation and amortization | (17,900) | (16,729) |
| | 4,227 | 4,776 |
| Construction in progress | 143 | 47 |
| Total | <u>\$ 4,370</u> | <u>\$ 4,823</u> |

Depreciation expense was \$1.2 million and \$1.3 million for the years ended December 31, 2019 and 2018, respectively.

(12) Deposits

Deposit accounts by type are summarized with their respective weighted-average interest rates as follows:

| (Dollars in thousands) | December 31, | | | |
|-------------------------|---------------------|--------|---------------------|--------|
| | 2019 | | 2018 | |
| | Amount | Rate | Amount | Rate |
| Non-interest bearing | \$ 54,927 | - % | \$ 51,744 | - % |
| Savings accounts | 908,175 | 0.49 | 991,310 | 0.50 |
| Certificates of deposit | 463,943 | 1.87 | 391,141 | 1.89 |
| Money market | 4,917 | 0.45 | 5,291 | 0.44 |
| Checking and Super NOW | 199,971 | 0.02 | 189,678 | 0.02 |
| Total | <u>\$ 1,631,933</u> | 0.81 % | <u>\$ 1,629,164</u> | 0.77 % |

The maturity of certificate of deposit accounts at December 31, 2019 is as follows (dollars in thousands):

| | |
|--------------|-------------------|
| Maturing in: | |
| 2020 | \$ 310,465 |
| 2021 | 88,002 |
| 2022 | 38,394 |
| 2023 | 14,666 |
| 2024 | 12,416 |
| Total | <u>\$ 463,943</u> |

Certificates of deposit with balances greater than or equal to \$250,000 totaled \$272.7 million and \$244.6 million at December 31, 2019 and 2018, respectively. Deposit accounts in the Bank are insured by the FDIC, generally up to a maximum of \$250,000 per account owner.

Interest expense by type of deposit is as follows:

| | | |
|--|------------------|------------------|
| (Dollars in thousands) | 2019 | 2018 |
| Savings | \$ 4,593 | \$ 4,842 |
| Certificates of deposit and money market | 8,829 | 6,134 |
| Checking and Super NOW | 41 | 39 |
| Total | <u>\$ 13,463</u> | <u>\$ 11,015</u> |

At December 31, 2019 and 2018, overdrawn deposit accounts totaled \$37,000 and \$34,000, respectively, and have been reclassified as loans in the consolidated balance sheets.

(13) Advances from the Federal Home Loan Bank

Federal Home Loan Bank advances are secured by a blanket pledge on the Bank's assets not otherwise pledged. At December 31, 2019 and 2018, our credit line with the FHLB Des Moines was equal to 45% of the Bank's total assets and we had the capacity to borrow an additional \$727.5 million and \$769.3 million, respectively.

Advances outstanding consisted of the following:

| | | | | |
|-------------------------------|---------------------|--------------------------------------|-------------------|--------------------------------------|
| | December 31, | | | |
| | 2019 | | 2018 | |
| (Dollars in thousands) | Amount | Weighted Average Rate | Amount | Weighted Average Rate |
| Due within one year | \$ 20,000 | 2.16 % | \$ 107,200 | 2.39 % |
| Due over 1 year to 2 years | 57,000 | 2.50 | 20,000 | 2.16 |
| Due over 2 years to 3 years | 30,000 | 2.37 | 15,000 | 2.32 |
| Due over 3 years to 4 years | 19,000 | 2.16 | — | — |
| Due over 4 years to 5 years | 30,000 | 1.87 | — | — |
| Total | <u>\$ 156,000</u> | 2.27 % | <u>\$ 142,200</u> | 2.35 % |

(14) Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase are treated as financings and the obligations to repurchase the identical securities sold are reflected as a liability with the securities collateralizing the agreements classified as an asset. Securities sold under agreements to repurchase are summarized as follows:

| (Dollars in thousands) | 2019 | | 2018 | |
|------------------------|----------------------|-----------------------|----------------------|-----------------------|
| | Repurchase Liability | Weighted Average Rate | Repurchase Liability | Weighted Average Rate |
| Maturing: | | | | |
| 1 year or less | \$ 5,000 | 1.65 % | \$ 25,000 | 1.66 % |
| Over 1 year to 2 years | — | — | 5,000 | 1.65 |
| Over 4 year to 5 years | 5,000 | 1.88 | — | — |
| Total | <u>\$ 10,000</u> | <u>1.77 %</u> | <u>\$ 30,000</u> | <u>1.66 %</u> |

Below is a summary comparing the carrying value and fair value of securities pledged to secure repurchase agreements, the repurchase liability, and the amount at risk at December 31, 2019. The amount at risk is the greater of the carrying value or fair value over the repurchase liability and refers to the potential loss to the Company if the secured lender fails to return the security at the maturity date of the agreement. All the agreements to repurchase are with JP Morgan Securities and the securities pledged are mortgage-backed securities issued and guaranteed by U.S. government sponsored enterprises. The repurchase liability cannot exceed 90% of the fair value of securities pledged. In the event of a decline in the fair value of securities pledged to less than the required amount due to market conditions or principal repayments, the Company is obligated to pledge additional securities or other suitable collateral to cure the deficiency.

| (Dollars in thousands) | Carrying Value of Securities | Fair Value of Securities | Repurchase Liability | Amount at Risk | Weighted Average Months to Maturity |
|------------------------|------------------------------|--------------------------|----------------------|----------------|-------------------------------------|
| Maturing: | | | | | |
| Over 90 days | \$ 11,724 | \$ 12,201 | \$ 10,000 | \$ 2,201 | 30 |

(15) Offsetting of Financial Liabilities

Securities sold under agreements to repurchase are subject to a right of offset in the event of default. See Note 14, Securities Sold Under Agreements to Repurchase, for additional information.

| (Dollars in thousands) | Gross Amount of Recognized Liabilities | Gross Amount Offset in the Balance Sheet | Net Amount of Liabilities Presented in the Balance Sheet | Gross Amount Not Offset in the Balance Sheet | | Net Amount |
|--|--|--|--|--|-------------------------|------------|
| | | | | Financial Instruments | Cash Collateral Pledged | |
| December 31, 2019: | | | | | | |
| Securities sold under agreements to repurchase | \$ 10,000 | \$ — | \$ 10,000 | \$ 10,000 | \$ — | \$ — |
| December 31, 2018: | | | | | | |
| Securities sold under agreements to repurchase | \$ 30,000 | \$ — | \$ 30,000 | \$ 30,000 | \$ — | \$ — |

(16) Income Taxes

Allocation of federal and state income taxes between current and deferred provisions is as follows:

| (Dollars in thousands) | 2019 | 2018 |
|------------------------|-----------------|-----------------|
| Current | | |
| Federal | \$ 3,366 | \$ 3,752 |
| State | 1,479 | 1,530 |
| | <u>4,845</u> | <u>5,282</u> |
| Deferred | | |
| Federal | 1,147 | 600 |
| State | 319 | 229 |
| | <u>1,466</u> | <u>829</u> |
| Total | <u>\$ 6,311</u> | <u>\$ 6,111</u> |

The federal statutory corporate tax rate for the years ended December 31, 2019 and 2018 was 21%. A reconciliation of the tax provision based on the statutory corporate rate on pretax income and the provision for taxes as shown in the accompanying Consolidated Statements of Income is as follows:

| (Dollars in thousands) | 2019 | 2018 |
|--|-----------------|-----------------|
| Income tax expense at statutory rate | \$ 5,944 | \$ 5,318 |
| Income tax effect of: | | |
| Other tax-exempt income | (263) | (182) |
| Share-based compensation | (69) | 1 |
| Meal and entertainment expenses | 82 | 88 |
| State income taxes, net of federal income tax benefits | 1,301 | 1,246 |
| Tax benefit from the exercise of stock options | (297) | (134) |
| Tax benefit from tax depreciation study (1) | (402) | — |
| Other | 15 | (226) |
| Total income tax expense | <u>\$ 6,311</u> | <u>\$ 6,111</u> |
| Effective income tax rate | 22.29 % | 24.13 % |

- (1) The Company conducted a study that reduced the asset lives used to calculate depreciation. The Company filed an amended tax return and was able to deduct the increase in depreciation expense at the 2017 federal corporate tax rate of 35% rather than the current 21% federal corporate tax rate.

The components of income taxes payable (receivable) are as follows:

| (Dollars in thousands) | December 31, | |
|----------------------------|-------------------|-------------------|
| | 2019 | 2018 |
| Current taxes payable: | | |
| Federal | \$ 767 | \$ 621 |
| State | 1,538 | 1,786 |
| | <u>\$ 2,305</u> | <u>\$ 2,407</u> |
| Deferred taxes receivable: | | |
| Federal | \$ (1,651) | \$ (2,836) |
| State | (968) | (1,300) |
| | <u>\$ (2,619)</u> | <u>\$ (4,136)</u> |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

| (Dollars in thousands) | December 31, | |
|--|--------------|----------|
| | 2019 | 2018 |
| Deferred tax assets: | | |
| Premises and equipment | \$ 547 | \$ 1,037 |
| Hawaii franchise tax | 479 | 468 |
| Unfunded pension liability | 925 | 691 |
| Allowance for loan losses | 722 | 703 |
| Impaired asset write-down | — | 765 |
| Employee benefit plans | 2,692 | 2,601 |
| Equity incentive plan | 350 | 399 |
| Unrealized losses on securities available-for-sale | — | 32 |
| Deferred compensation | 413 | 480 |
| Net lease liability | 161 | — |
| Other | 8 | 159 |
| | 6,297 | 7,335 |
| Deferred tax liabilities: | | |
| Deferred loan costs | 3,078 | 2,844 |
| FHLB stock dividends | 126 | 126 |
| Prepaid expense | 155 | 169 |
| Unrealized gain on securities available-for-sale | 185 | — |
| Premiums on loans sold | 134 | 60 |
| | 3,678 | 3,199 |
| Net deferred tax assets | \$ 2,619 | \$ 4,136 |

Deferred tax assets and liabilities at December 31, 2019 and 2018 were calculated using federal corporate tax rates of 21%.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not the Company will realize the benefits of these deductible differences. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced. There was no valuation allowance for deferred tax assets as of December 31, 2019 and 2018.

(17) Employee Benefit Plans

The Company has a noncontributory defined benefit pension plan (Pension Plan) that covers most employees with at least one year of service. The benefits are based on years of service and the employees' compensation during the service period. The Company's policy is to accrue the actuarially determined pension costs and to fund pension costs within regulatory guidelines. The Company reviews its assumptions on an annual basis and makes modifications to the assumptions based on current rates and trends when it is appropriate to do so. The effect of modifications to those assumptions is recorded in accumulated other comprehensive income (AOCI) beginning in 2006 and amortized to net periodic benefit cost over future periods using the corridor method. The Company believes that the assumptions utilized in recording its obligations under the plan are reasonable based on its experience and market conditions.

In 2008, the Board of Directors approved changes to the Company's defined benefit pension plan. Effective December 31, 2008, there are no further accruals of benefits for any participants and benefits do not increase with

any additional years of service. Employees already enrolled in the Pension Plan as of December 31, 2008 will be 100% vested if they have at least five years of service. For employees with less than five years of service, vesting would occur at the employee's five-year anniversary date.

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

The following table sets forth the status of the Pension Plan and SERP at the dates indicated:

| (Dollars in thousands) | Pension Plan | | SERP | |
|---|--------------|------------|------------|------------|
| | December 31, | | | |
| | 2019 | 2018 | 2019 | 2018 |
| Accumulated benefit obligation at end of year | \$ 21,367 | \$ 18,713 | \$ 9,702 | \$ 9,473 |
| Change in projected benefit obligation: | | | | |
| Benefit obligation at beginning of year | \$ 18,713 | \$ 19,314 | \$ 9,473 | \$ 9,242 |
| Service cost | 164 | 141 | 84 | 97 |
| Interest cost | 811 | 728 | 162 | 151 |
| Actuarial loss (gain) | 2,558 | (611) | — | — |
| Benefits paid | (879) | (859) | (17) | (17) |
| Benefit obligation at end of year | 21,367 | 18,713 | 9,702 | 9,473 |
| Change in plan assets: | | | | |
| Fair value of plan assets at beginning of year | 17,500 | 15,927 | — | — |
| Actual return on plan assets | 2,814 | (968) | — | — |
| Employer contributions | — | 3,400 | 17 | 17 |
| Benefits paid | (879) | (859) | (17) | (17) |
| Fair value of plan assets at end of year | 19,435 | 17,500 | — | — |
| Funded status at end of year | \$ (1,932) | \$ (1,213) | \$ (9,702) | \$ (9,473) |
| Amounts recognized in the Consolidated Balance Sheets: | | | | |
| Accounts payable and accrued expenses - liability | \$ (1,932) | \$ (1,213) | \$ (9,702) | \$ (9,473) |
| Amounts recognized in accumulated other comprehensive loss: | | | | |
| Net actuarial loss | \$ 11,008 | \$ 10,380 | \$ — | \$ — |
| Prior service cost | 139 | 144 | — | — |
| Accumulated other comprehensive loss, before tax | \$ 11,147 | \$ 10,524 | \$ — | \$ — |

The following table sets forth the changes recognized in accumulated other comprehensive loss for the years indicated:

| (Dollars in thousands) | Pension Plan | |
|---|-------------------------|-----------|
| | Year Ended December 31, | |
| | 2019 | 2018 |
| Accumulated other comprehensive loss at beginning of year, before tax | \$ 10,524 | \$ 9,245 |
| Actuarial net loss arising during the period | 961 | 1,562 |
| Amortizations (recognized in net periodic benefit cost): | | |
| Actuarial loss | (333) | (278) |
| Prior service cost | (5) | (5) |
| Total recognized in other comprehensive loss | 623 | 1,279 |
| Accumulated other comprehensive loss at end of year, before tax | \$ 11,147 | \$ 10,524 |

For the years ended December 31, 2019 and 2018, the following weighted average assumptions were used to determine benefit obligations at the end of the year:

| Assumptions used to determine the year-end benefit obligations: | Pension Plan | | SERP | |
|---|-------------------------|--------|--------|--------|
| | Year Ended December 31, | | | |
| | 2019 | 2018 | 2019 | 2018 |
| Discount rate | 3.30 % | 4.30 % | 5.02 % | 5.03 % |
| Rate of compensation increase | N/A | N/A | 5.00 % | 5.00 % |

The Company does not expect any plan assets to be returned to the Company during calendar year 2020.

The dates used to determine retirement measurements for the Pension Plan were December 31, 2019 and 2018.

The Company's investment strategy for the defined benefit retirement plan is to maintain a consistent rate of return with primary emphasis on capital appreciation and secondary emphasis on income to enhance the purchasing power of the plan's assets over the long-term and to preserve capital. The investment policy establishes a target allocation for each asset class that is reviewed periodically and rebalanced when considered appropriate. Normal target allocations at December 31, 2019 were 55% domestic equity securities, 10% international equity securities and 35% bonds. Equity securities primarily include stocks, investment in exchange traded funds and large-cap, mid-cap and small-cap mutual funds. Bonds include U.S. Treasuries, mortgage-backed securities and corporate bonds of companies in diversified industries. Other types of investments include money market funds and savings accounts opened with the Company.

As of December 31, 2019 and 2018, the Pension Plan's assets measured at fair value were classified as follows:

| (Dollars in thousands) | Total Fair Value | Fair Value of Measurements at Report Date Using: | | |
|---------------------------|------------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2019: | | | | |
| Cash | \$ 3,021 | \$ 3,021 | \$ — | \$ — |
| Equities | 11,576 | 11,576 | — | — |
| Mutual funds (1) | 4,838 | 4,838 | — | — |
| Total | <u>\$ 19,435</u> | <u>\$ 19,435</u> | <u>\$ —</u> | <u>\$ —</u> |
| December 31, 2018: | | | | |
| Cash | \$ 4,128 | \$ 4,128 | \$ — | \$ — |
| Equities | 9,008 | 9,008 | — | — |
| Mutual funds (1) | 4,364 | 4,364 | — | — |
| Total | <u>\$ 17,500</u> | <u>\$ 17,500</u> | <u>\$ —</u> | <u>\$ —</u> |

(1) This category includes mutual funds that invest in equities and bonds. The mutual fund managers have the ability to change the amounts invested in equities and bonds depending on their investment outlook.

Estimated future benefit payments reflecting expected future service at December 31, 2019 are as follows:

| (Dollars in thousands) | Pension Plan | SERP |
|-------------------------------|-------------------------|-----------------|
| 2020 | \$ 1,195 | \$ 17 |
| 2021 | 1,263 | 8,639 |
| 2022 | 1,303 | 160 |
| 2023 | 1,309 | 149 |
| 2024 | 1,317 | 149 |
| 2025 - 2029 | 6,447 | 743 |
| Total | <u>\$ 12,834</u> | <u>\$ 9,857</u> |

For the years ended December 31, 2019 and 2018, the following weighted average assumptions were used to determine net periodic benefit cost for the fiscal years shown:

| (Dollars in thousands) | Pension Plan | | SERP | |
|--|--------------------------------|-------------|-------------|-------------|
| | Year Ended December 31, | | | |
| | 2019 | 2018 | 2019 | 2018 |
| Assumptions used to determine the net periodic benefit cost: | | | | |
| Discount rate | 4.30 % | 3.70 % | 5.02 % | 5.02 % |
| Expected return on plan assets | 7.25 | 7.25 | - | - |
| Rate of compensation increase | N/A | N/A | 5.00 | 5.00 |

The components of net periodic benefit cost were as follows:

| (Dollars in thousands) | Pension Plan | | SERP | |
|--|--------------------------------|----------------|---------------|---------------|
| | Year Ended December 31, | | | |
| | 2019 | 2018 | 2019 | 2018 |
| Net periodic benefit cost (income) for the year: | | | | |
| Service cost | \$ 164 | \$ 141 | \$ 84 | \$ 97 |
| Interest cost | 811 | 728 | 162 | 151 |
| Expected return on plan assets | (1,217) | (1,204) | — | — |
| Amortization of prior service cost | 5 | 5 | — | — |
| Recognized actuarial loss | 333 | 278 | — | — |
| Recognized curtailment loss | — | — | — | — |
| Net periodic benefit cost (income) for the year: | <u>\$ 96</u> | <u>\$ (52)</u> | <u>\$ 246</u> | <u>\$ 248</u> |

The components of net periodic benefit cost other than the service cost component are included in other general and administrative expenses in the Consolidated Statements of Income. The service cost component of net periodic benefit costs is included in salaries and employee benefits.

The estimated prior service cost and net actuarial loss that will be amortized from AOCI into net periodic pension benefit cost in 2020 are \$5,000 and \$337,000, respectively.

The expected return on plan assets is based on the weighted-average long-term rates of return for the types of assets held in the plan. The expected return on plan assets is adjusted when there is a change in the expected long-term rate of return or in the composition of assets held in the plan. The discount rate is based on the return of high-quality fixed-income investments that can be used to fund the benefit payments under the Company's defined benefit plan.

The Company does not expect to make any contributions to the defined benefit pension plan in 2020. The Company expects to make a \$17,000 contribution to the SERP in 2020 to cover actual benefit payments.

The Company also has a 401(k) defined contribution plan and profit sharing plan covering all employees after one year of service. The 401(k) plan provides for employer matching contributions, as determined by the Company, based on a percentage of employees' contributions subject to a maximum amount defined in the plan agreement.

The Company's 401(k) matching contributions, based on 5% of employees' contributions for 2019 and 2018 amounted to \$62,000 and \$60,000, respectively. The Company contributes to the profit sharing plan an amount determined by the Board of Directors. No contributions were made to the profit sharing plan for years ended December 31, 2019 and 2018.

(18) Employee Stock Ownership Plan

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

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

Shares purchased by the ESOP are held by a trustee in an unallocated suspense account, and shares are released annually from the suspense account on a pro-rata basis as principal and interest payments are made by the ESOP to the Company. The trustee allocates the shares released among participants on the basis of each participant's proportional share of compensation relative to all participants. As shares are committed to be released from the suspense account, Territorial Savings Bank reports compensation expense based on the average fair value of shares released with a corresponding credit to stockholders' equity. The shares committed to be released are considered outstanding for earnings per share computations. Compensation expense recognized for the years ended December 31, 2019 and 2018 amounted to \$1.4 million and \$1.5 million, respectively.

Shares held by the ESOP trust were as follows:

| | December 31, | |
|---|---------------------|------------------|
| | 2019 | 2018 |
| Allocated shares | 466,807 | 446,041 |
| Unearned shares | 440,397 | 489,329 |
| Total ESOP shares | <u>907,204</u> | <u>935,370</u> |
| Fair value of unearned shares, in thousands | <u>\$ 13,626</u> | <u>\$ 12,713</u> |

The ESOP restoration plan is a non-qualified plan that provides supplemental benefits to certain executives who are prevented from receiving the full benefits contemplated by the ESOP's benefit formula. The supplemental cash payments consist of payments representing shares that cannot be allocated to the participants under the ESOP due to IRS limitations imposed on tax-qualified plans. We accrue for these benefits over the period during which employees provide services to earn these benefits. For the years ended December 31, 2019 and 2018, we accrued \$350,000 and \$204,000, respectively, for the ESOP restoration plan.

(19) Share-Based Compensation

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

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

| <u>(In thousands)</u> | <u>2019</u> | <u>2018</u> |
|-----------------------|-------------|-------------|
| Compensation expense | \$ 571 | \$ 341 |
| Income tax benefit | 156 | 93 |

Shares of our common stock issued under the 2010 Equity Incentive Plan shall be authorized shares. The maximum number of shares that will be awarded under the plan is 1,862,637 shares.

Stock Options

The table below presents the stock option activity of the Company:

| | <u>Options</u> | <u>Weighted Average Exercise Price</u> | <u>Remaining Contractual Life (years)</u> | <u>Aggregate Intrinsic Value (in thousands)</u> |
|---|----------------|--|---|---|
| Options outstanding at December 31, 2017 | 411,543 | \$ 17.48 | 2.73 | \$ 5,509 |
| Granted | — | — | — | — |
| Exercised | 73,889 | 17.36 | — | 973 |
| Forfeited | — | — | — | — |
| Expired | — | — | — | — |
| Options outstanding at December 31, 2018 | 337,654 | \$ 17.51 | 1.74 | \$ 2,859 |
| Granted | — | — | — | — |
| Exercised | 221,245 | 17.50 | — | 2,483 |
| Forfeited | — | — | — | — |
| Expired | — | — | — | — |
| Options outstanding at December 31, 2019 | <u>116,409</u> | \$ 17.53 | 0.72 | \$ 1,562 |
| Options vested and exercisable at December 31, 2019 | 116,409 | \$ 17.53 | 0.72 | \$ 1,562 |

The following summarizes certain stock option activity of the Company:

| <u>(In thousands)</u> | <u>2019</u> | <u>2018</u> |
|--|-------------|-------------|
| Intrinsic value of stock options exercised | \$ 2,483 | \$ 973 |
| Proceeds received from stock options exercised | 3,873 | 1,283 |
| Tax benefits realized from stock options exercised | 534 | 229 |
| Total fair value of stock options that vested | — | 35 |

During the year ended December 31, 2019, the Company issued 91,840 shares of common stock in exchange for 221,245 stock options and 129,405 common shares. Pursuant to the provisions of our equity incentive plan, optionees are permitted to use the value of common stock they own in a stock swap transaction or use a net settlement method to pay the exercise price of stock options.

As of December 31, 2019, the Company had no unrecognized compensation costs related to the stock option plan.

Restricted Stock

Restricted stock is accounted for as a fixed grant using the fair value of the Company's stock at the time of grant. Unvested restricted stock may not be disposed of or transferred during the vesting period. Restricted stock carries

the right to receive dividends, although dividends attributable to restricted stock may be retained by the Company until the shares vest, at which time they are paid to the award recipient.

The table below presents the restricted stock activity:

| | Restricted Stock | Weighted Average Grant Date Fair Value |
|-------------------------------|-----------------------------|---|
| Unvested at December 31, 2017 | 10,806 | \$ 29.16 |
| Granted | 10,019 | 30.73 |
| Vested | 4,401 | 28.63 |
| Forfeited | — | — |
| Unvested at December 31, 2018 | <u>16,424</u> | \$ 30.26 |
| Unvested at December 31, 2018 | 16,424 | \$ 30.26 |
| Granted | 10,366 | 27.30 |
| Vested | 6,541 | 30.14 |
| Forfeited | — | — |
| Unvested at December 31, 2019 | <u>20,249</u> | \$ 28.78 |

During the year ended December 31, 2019, the Company issued 10,336 shares of restricted stock to certain members of executive management under the 2010 Equity Incentive Plan. The fair value of the restricted stock is based on the value of the Company's stock on the date of grant. Restricted stock will vest over three years from the date of the grant.

As of December 31, 2019, the Company had \$365,000 of unrecognized compensation costs related to time-vested restricted stock. The unrecognized compensation costs are expected to be recognized over a weighted average period of 1.7 years.

During the year ended December 31, 2019, the Company issued 12,438 of performance-based restricted stock units (PRsUs) to certain members of executive management under the 2010 Equity Incentive Plan. These PRsUs will vest in the first quarter of 2022 after our Compensation Committee determines whether a performance condition that compares the Company's return on average equity to the SNL Bank Index is achieved. Depending on the Company's performance, the actual number of these PRsUs that are issued at the end of the vesting period can vary between 0% to 150% of the target award. For the PRsUs, an estimate is made of the number of shares expected to vest based on the probability that the performance criteria will be achieved to determine the amount of compensation expense to be recognized. This estimate is re-evaluated quarterly and total compensation expense is adjusted for any change in the current period.

The table below presents the PRSUs that will vest on a performance condition:

| | Performance- Based Restricted Stock Units Based on a Performance Condition | Weighted Average Grant Date Fair Value |
|-------------------------------|---|---|
| Unvested at December 31, 2017 | 11,520 | \$ 29.53 |
| Granted | 12,018 | 30.73 |
| Vested | — | — |
| Forfeited | — | — |
| Unvested at December 31, 2018 | <u>23,538</u> | \$ 30.14 |
| Unvested at December 31, 2018 | 23,538 | \$ 30.14 |
| Granted | 12,438 | 27.30 |
| Vested | — | — |
| Forfeited | — | — |
| Unvested at December 31, 2019 | <u>35,976</u> | \$ 29.16 |

The fair value of these PRSUs is based on the fair value of the Company's stock on the date of grant. As of December 31, 2019, the Company had \$311,000 of unrecognized compensation costs related to these PRSUs. The unrecognized compensation costs are expected to be recognized over a weighted average period of 1.9 years. Performance will be measured over a three-year period and will be cliff vested.

During the year ended December 31, 2019, the Company issued 3,110 of PRSUs to certain members of executive management under the 2010 Equity Incentive Plan. These PRSUs will vest in the first quarter of 2022 after our Compensation Committee determines whether a market condition that compares the Company's total stock return to the SNL Bank Index is achieved. The number of shares that will be expensed will not be adjusted for performance. The fair value of these PRSUs is based on a Monte Carlo valuation of the Company's stock on the date of grant. The assumptions which were used in the Monte Carlo valuation of the PRSUs are:

Grant date: March 7, 2019
Performance period: January 1, 2019 to December 31, 2021
2.82 year risk-free rate on grant date: 2.45%
December 31, 2018 closing price: \$25.98
Closing stock price on date of grant: \$27.30
Annualized volatility (based on 2.82 year historical volatility as of the grant date): 15.1%

The table below presents the PRSUs that will vest on a market condition:

| | Performance- Based Restricted Stock Units Based on a Market Condition | Monte Carlo Valuation of the Company's Stock |
|-------------------------------|--|---|
| Unvested at December 31, 2017 | 2,879 | \$ 24.44 |
| Granted | 3,005 | 28.32 |
| Vested | — | — |
| Forfeited | — | — |
| Unvested at December 31, 2018 | <u>5,884</u> | \$ 26.42 |
| Unvested at December 31, 2018 | 5,884 | \$ 26.42 |
| Granted | 3,110 | 24.45 |
| Vested | — | — |
| Forfeited | — | — |
| Unvested at December 31, 2019 | <u><u>8,994</u></u> | \$ 25.74 |

As of December 31, 2019, the Company had \$67,000 of unrecognized compensation costs related to the PRSUs that are based on a market condition. The unrecognized compensation costs are expected to be recognized over a weighted average period of 1.9 years. Performance will be measured over a three-year period and will be cliff vested.

On May 16, 2019, shareholders of Territorial Bancorp Inc. adopted the 2019 Equity Incentive Plan, which provides for the award of 15,000 stock options and restricted stock to key officers and directors. As of December 31, 2019, no awards have been granted under the 2019 Equity Incentive Plan.

(20) Earnings Per Share

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

| (Dollars in thousands, except per share data) | For the Year Ended December 31, | |
|--|--|-------------------------|
| | 2019 | 2018 |
| Net income | \$ 21,995 | \$ 19,212 |
| Income allocated to participating securities | (149) | (90) |
| Net income available to common shareholders | <u>\$ 21,846</u> | <u>\$ 19,122</u> |
| Weighted-average number of shares used in: | | |
| Basic earnings per share | 9,196,674 | 9,219,123 |
| Dilutive common stock equivalents: | | |
| Stock options and restricted stock units | <u>128,940</u> | <u>181,272</u> |
| Diluted earnings per share | <u><u>9,325,614</u></u> | <u><u>9,400,395</u></u> |
| Net income per common share, basic | <u>\$ 2.38</u> | <u>\$ 2.07</u> |
| Net income per common share, diluted | <u>\$ 2.34</u> | <u>\$ 2.03</u> |

(21) Other Comprehensive Loss

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

| <u>(Dollars in thousands)</u> | <u>Unfunded Pension Liability</u> | <u>Unrealized (Gain)/Loss on Securities</u> | <u>Total</u> |
|--|---|---|-----------------|
| December 31, 2019: | | | |
| Balances at beginning of year | \$ 7,721 | \$ 88 | \$ 7,809 |
| Other comprehensive loss (income), net of taxes | 457 | (598) | (141) |
| Net current period other comprehensive loss (income) | 457 | (598) | (141) |
| Balances at end of year | <u>\$ 8,178</u> | <u>\$ (510)</u> | <u>\$ 7,668</u> |
| December 31, 2018: | | | |
| Balances at beginning of year | \$ 5,657 | \$ 37 | \$ 5,694 |
| Other comprehensive loss, net of taxes | 938 | 42 | 980 |
| Amounts reclassified from retained earnings | 1,126 | 9 | 1,135 |
| Net current period other comprehensive loss | 2,064 | 51 | 2,115 |
| Balances at end of year | <u>\$ 7,721</u> | <u>\$ 88</u> | <u>\$ 7,809</u> |

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

| <u>(Dollars in thousands)</u> | <u>Year Ended December 31,</u> | | | | | |
|--------------------------------------|--------------------------------|--------------|-----------------------------|--------------------------|-----------------|-----------------------------|
| | <u>2019</u> | | | <u>2018</u> | | |
| | <u>Pretax Amount</u> | <u>Tax</u> | <u>After Tax Amount</u> | <u>Pretax Amount</u> | <u>Tax</u> | <u>After Tax Amount</u> |
| Unfunded pension liability | \$ 623 | \$ (166) | \$ 457 | \$ 1,279 | \$ (341) | \$ 938 |
| Unrealized (gain)/loss on securities | (815) | 217 | (598) | 57 | (15) | 42 |
| Total | <u>\$ (192)</u> | <u>\$ 51</u> | <u>\$ (141)</u> | <u>\$ 1,336</u> | <u>\$ (356)</u> | <u>\$ 980</u> |

(22) Commitments

(a) *Loan Commitments*

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any terms or conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on an individual basis. The Company's policy is to require suitable collateral, primarily real estate, to be provided by customers prior to disbursement of approved loans. At December 31, 2019 and 2018, the Company had loan commitments aggregating to \$8.7 million (interest rates from 3.375% to 4.000%) and \$7.9 million (interest rates from 4.125% to 5.000%), respectively, primarily consisting of fixed-rate residential first mortgage loans. In addition to commitments to originate loans, at December 31, 2019 and 2018, the Company had \$24.5 million and \$26.9 million, respectively, in unused lines of credit to borrowers.

(b) *Reserve Requirements*

The Company is required by the Federal Reserve Bank to maintain reserves based on the amount of deposits held. The reserve requirement at December 31, 2019 and 2018 was \$13.5 million and \$11.9 million, respectively, and the Company met such requirements.

(23) Regulatory Capital and Supervision

Territorial Savings Bank and the Company are subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. Effective January 1, 2015, the well capitalized threshold for Tier 1 risk-based capital was increased from 6.0% to 8.0% and a new capital standard, common equity tier 1 risk-based capital, was implemented with a 6.5% ratio requirement for a financial institution to be considered well capitalized. Additionally, effective January 1, 2015, consolidated regulatory capital requirements identical to those applicable to the subsidiary depository institutions became applicable to savings and loan holding companies over \$1.0 billion in assets, such as the Company. This asset level was increased to \$3.0 billion in 2018. Accordingly, the Company is no longer subject to regulatory capital requirements because its total assets are less than \$3.0 billion. The capital requirements became fully-phased in on January 1, 2019. At December 31, 2019 and 2018, Territorial Savings Bank exceeded all of the fully-phased in regulatory capital requirements and is considered to be “well capitalized” under regulatory guidelines. In addition to establishing the minimum regulatory capital requirements, the regulations limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets above the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement was being phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increased each year until fully implemented at 2.5% on January 1, 2019.

The table below presents the fully-phased in capital required to be considered “well-capitalized” and meet the capital conservation buffer requirement as a percentage of total and risk-weighted assets and the percentage and the total amount of capital maintained for Territorial Savings Bank and the Company at December 31, 2019 and 2018:

| (Dollars in thousands) | <u>Required Ratio</u> | <u>Actual Amount</u> | <u>Actual Ratio</u> |
|---|-----------------------|----------------------|---------------------|
| December 31, 2019: | | | |
| Tier 1 Leverage Capital | | | |
| Territorial Savings Bank | 5.00 % | \$ 227,507 | 10.92 % |
| Territorial Bancorp Inc. | | \$ 251,558 | 12.06 % |
| Common Equity Tier 1 Risk-Based Capital (1) | | | |
| Territorial Savings Bank | 9.00 % | \$ 227,507 | 23.31 % |
| Territorial Bancorp Inc. | | \$ 251,558 | 25.77 % |
| Tier 1 Risk-Based Capital (1) | | | |
| Territorial Savings Bank | 10.50 % | \$ 227,507 | 23.31 % |
| Territorial Bancorp Inc. | | \$ 251,558 | 25.77 % |
| Total Risk-Based Capital (1) | | | |
| Territorial Savings Bank | 12.50 % | \$ 230,304 | 23.59 % |
| Territorial Bancorp Inc. | | \$ 254,355 | 26.06 % |
| December 31, 2018: | | | |
| Tier 1 Leverage Capital | | | |
| Territorial Savings Bank | 5.00 % | \$ 225,694 | 11.09 % |
| Territorial Bancorp Inc. | | \$ 242,888 | 11.92 % |
| Common Equity Tier 1 Risk-Based Capital (1) | | | |
| Territorial Savings Bank | 9.00 % | \$ 225,694 | 23.50 % |
| Territorial Bancorp Inc. | | \$ 242,888 | 25.29 % |
| Tier 1 Risk-Based Capital (1) | | | |
| Territorial Savings Bank | 10.50 % | \$ 225,694 | 23.50 % |
| Territorial Bancorp Inc. | | \$ 242,888 | 25.29 % |
| Total Risk-Based Capital (1) | | | |
| Territorial Savings Bank | 12.50 % | \$ 228,423 | 23.78 % |
| Territorial Bancorp Inc. | | \$ 245,617 | 25.57 % |

- (1) The required Common Equity Tier 1 Risk-Based Capital, Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios are based on the fully-phased in capital ratios in the Basel III capital regulations plus the 2.50% capital conservation buffer that became effective on January 1, 2019.

Prompt Corrective Action provisions define specific capital categories based on an institution’s capital ratios. However, the regulators may impose higher minimum capital standards on individual institutions or may downgrade an institution from one capital category to a lower category because of safety and soundness concerns. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company’s Consolidated Financial Statements.

Prompt Corrective Action provisions impose certain restrictions on institutions that are undercapitalized. The restrictions imposed become increasingly more severe as an institution’s capital category declines from “undercapitalized” to “critically undercapitalized.”

At December 31, 2019 and 2018, the Bank’s capital ratios exceeded the minimum capital thresholds for a “well-capitalized” institution. There are no conditions or events that have changed the institution’s category under the capital guidelines.

Depending on the amount of dividends to be paid, the Bank is required to either notify or make application to the Federal Reserve Bank before dividends are paid to the parent company.

Legislation enacted in 2018 requires the federal banking agencies, including the Federal Reserve Board, to establish a “community bank leverage ratio” between 8% to 10% of average total consolidated assets for qualifying institutions with assets of less than \$10 billion. Institutions with capital meeting the specified requirements and electing to follow the alternative framework would be deemed to comply with the applicable regulatory capital requirements, including the risk based requirements. The federal regulators have adopted 9% as the applicable ratio, effective March 31, 2020. The Bank is not planning to adopt the alternative framework, with the applicable regulatory requirements.

(24) Contingencies

The Company is involved in various claims and legal actions arising out of the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company’s Consolidated Balance Sheets or Consolidated Statements of Income.

(25) Revenue Recognition

The Company’s contracts with customers are generally short-term in nature, with cycles of one year or less. These can range from an immediate term for services such as wire transfers, foreign currency exchanges and cashier’s check purchases, to several days for services such as processing annuity and mutual fund sales. Some contracts may be of an ongoing nature, such as providing deposit account services, including ATM access, check processing, account analysis and check ordering. However, provision of an assessable service and payment for such service is usually concurrent or closely timed. Contracts related to financial instruments, such as loans, investments and debt, are excluded from the scope of this reporting requirement.

After analyzing the Company’s revenue sources, including the amount of revenue received, the timing of services rendered and the timing of payment for these services, the Company has determined that the rendering of services and the payment for such services are generally closely matched. Any differences are not material to the Company’s Consolidated Financial Statements. Accordingly, the Company generally records income when payment for services is received.

Revenue from contracts with customers is reported in service fees on loan and deposit accounts and in other noninterest income in the Consolidated Statements of Income. The table below reconciles the revenue from contracts with customers and other revenue reported in those line items:

| (Dollars in thousands) | Service Fees on Loan and Deposit Accounts | Other | Total |
|---------------------------------------|---|---------------|-----------------|
| Year ended December 31, 2019 | | | |
| Revenue from contracts with customers | \$ 1,378 | \$ 150 | \$ 1,528 |
| Other revenue | 559 | 460 | 1,019 |
| Total | <u>\$ 1,937</u> | <u>\$ 610</u> | <u>\$ 2,547</u> |
| Year ended December 31, 2018 | | | |
| Revenue from contracts with customers | \$ 1,401 | \$ 138 | \$ 1,539 |
| Other revenue | 485 | 158 | 643 |
| Total | <u>\$ 1,886</u> | <u>\$ 296</u> | <u>\$ 2,182</u> |

(26) Leases

The table below presents lease costs and other information as of December 31, 2019:

| (Dollars in thousands) | December 31, 2019 | |
|---|-------------------|--------------|
| Lease Costs: | | |
| Operating lease costs | \$ | 3,130 |
| Short-term lease costs | | 57 |
| Variable lease costs | | 129 |
| Total lease costs | \$ | <u>3,316</u> |
| Cash paid for amounts included in measurement of lease liabilities | \$ | 2,991 |
| ROU assets obtained in exchange for new operating lease liabilities | \$ | 14,341 |

Total rental expense comprised minimum rentals of \$3.1 million for the year ended December 31, 2018.

At December 31, 2019, future minimum rental commitments under noncancellable operating leases are as follows:

| (Dollars in thousands) | | |
|-----------------------------|----|---------------|
| 2020 | \$ | 3,171 |
| 2021 | | 2,632 |
| 2022 | | 2,374 |
| 2023 | | 2,088 |
| 2024 | | 1,801 |
| Thereafter | | <u>3,112</u> |
| Total | | 15,178 |
| Less present value discount | | 2,995 |
| Present value of leases | \$ | <u>12,183</u> |

The table below presents other lease related information as of December 31, 2019:

| | December 31, 2019 |
|---|----------------------|
| Weighted-average remaining lease term (years) | 5.99 |
| Weighted-average discount rate | 2.76 % |

The Company leases to a tenant certain property that it owns. Future minimum rental income for this noncancellable lease is as follows:

| (Dollars in thousands) | | |
|------------------------|----|------------|
| 2020 | \$ | 110 |
| 2021 | | 110 |
| 2022 | | — |
| 2023 | | — |
| 2024 | | — |
| Thereafter | | — |
| Total | \$ | <u>220</u> |

Rental income comprised of minimum rentals for 2019 and 2018 was approximately \$110,000 each year.

(27) Fair Value of Financial Instruments

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

- Level 1 — Valuation is based upon quoted prices (unadjusted) for identical assets or liabilities traded in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.
- Level 2 — Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 — Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect management's own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of discounted cash flow models and similar techniques that require the use of significant judgment or estimation.

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

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

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

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

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

| (Dollars in thousands) | Carrying Amount | Fair Value | Fair Value Measurements Using | | |
|--|--------------------|------------|-------------------------------|-----------|-----------|
| | | | Level 1 | Level 2 | Level 3 |
| December 31, 2019 | | | | | |
| Assets | | | | | |
| Cash and cash equivalents | \$ 44,806 | \$ 44,806 | \$ 44,806 | \$ — | \$ — |
| Investment securities available for sale | 8,628 | 8,628 | — | 8,628 | — |
| Investment securities held to maturity | 363,883 | 371,305 | — | 371,305 | — |
| Loans held for sale | 470 | 480 | — | 480 | — |
| Loans receivable, net | 1,584,784 | 1,627,903 | — | — | 1,627,903 |
| FHLB stock | 8,723 | 8,723 | — | 8,723 | — |
| FRB stock | 3,128 | 3,128 | — | 3,128 | — |
| Accrued interest receivable | 5,409 | 5,409 | 32 | 952 | 4,425 |
| Interest rate contracts | 5 | 5 | — | 5 | — |
| Liabilities | | | | | |
| Deposits | 1,631,933 | 1,632,741 | — | 1,167,990 | 464,751 |
| Advances from the Federal Home Loan Bank | 156,000 | 156,906 | — | 156,906 | — |
| Securities sold under agreements to repurchase | 10,000 | 9,968 | — | 9,968 | — |
| Accrued interest payable | 397 | 397 | — | 47 | 350 |
| Interest rate contracts | 5 | 5 | — | 5 | — |
| December 31, 2018 | | | | | |
| Assets | | | | | |
| Cash and cash equivalents | \$ 47,063 | \$ 47,063 | \$ 47,063 | \$ — | \$ — |
| Investment securities available for sale | 2,560 | 2,560 | — | 2,560 | — |
| Investment securities held to maturity | 371,517 | 364,922 | — | 364,219 | 703 |
| Loans held for sale | 309 | 319 | — | 319 | — |
| Loans receivable, net | 1,574,714 | 1,553,672 | — | — | 1,553,672 |
| FHLB stock | 8,093 | 8,093 | — | 8,093 | — |
| FRB stock | 3,114 | 3,114 | — | 3,114 | — |
| Accrued interest receivable | 5,274 | 5,274 | 12 | 960 | 4,302 |
| Interest rate contracts | 5 | 5 | — | 5 | — |
| Liabilities | | | | | |
| Deposits | 1,629,164 | 1,626,587 | — | 1,238,023 | 388,564 |
| Advances from the Federal Home Loan Bank | 142,200 | 141,874 | — | 141,874 | — |
| Securities sold under agreements to repurchase | 30,000 | 29,876 | — | 29,876 | — |
| Accrued interest payable | 243 | 243 | — | 111 | 132 |
| Interest rate contracts | 5 | 5 | — | 5 | — |

At December 31, 2019 and 2018, neither the commitment fees received on commitments to extend credit nor the fair value thereof was material to the Consolidated Financial Statements of the Company.

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

| <u>(Dollars in thousands)</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|--|----------------|----------------|----------------|--------------|
| December 31, 2019 | | | | |
| Interest rate contracts — assets | \$ — | \$ 5 | \$ — | \$ 5 |
| Interest rate contracts — liabilities | — | (5) | — | (5) |
| Investment securities available for sale | — | 8,628 | — | 8,628 |
| December 31, 2018 | | | | |
| Interest rate contracts — assets | \$ — | \$ 5 | \$ — | \$ 5 |
| Interest rate contracts — liabilities | — | (5) | — | (5) |
| Investment securities available for sale | — | 2,560 | — | 2,560 |

The table below presents the balance of assets measured at fair value on a nonrecurring basis as of December 31, 2019 and the related losses for the year ended December 31, 2019. There were no assets measured at fair value on a nonrecurring basis as of December 31, 2018.

| <u>(Dollars in thousands)</u> | <u>Fair Value Adjustment Date</u> | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> | <u>Total Losses</u> |
|-------------------------------|-----------------------------------|----------------|----------------|----------------|--------------|---------------------|
| December 31, 2019 | | | | | | |
| Mortgage servicing assets | 9/30/2019 | \$ — | \$ — | \$ 452 | \$ 452 | \$ (16) |

Mortgage servicing assets are valued using a discounted cash flow model. Assumptions used in the model include mortgage prepayment speeds, discount rates and cost of servicing. Losses on mortgage servicing assets are included in service fees on loan and deposit accounts in the Consolidated Statements of Income.

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

| <u>(Dollars in thousands)</u> | <u>Fair Value</u> | <u>Valuation Technique</u> | <u>Unobservable Input</u> | <u>Value</u> |
|-------------------------------|-------------------|----------------------------|---|--------------|
| December 31, 2019: | | | | |
| Mortgage servicing assets | \$ 452 | Discounted cash flow | Discount rate | 10.25% |
| | | | Prepayment speed (CPR) | 9.11 - 13.06 |
| | | | Annual cost to service (per loan, in dollars) | \$ 75 |

(28) Parent Company Only

Presented below are the condensed balance sheet, statement of income, and statement of cash flows for Territorial Bancorp Inc.

Condensed Balance Sheet

| (Dollars in thousands) | December 31, | |
|--|-------------------|-------------------|
| | 2019 | 2018 |
| Assets | | |
| Cash | \$ 22,602 | \$ 16,389 |
| Investment in Territorial Savings Bank | 219,838 | 217,884 |
| Receivable from Territorial Savings Bank | 1,377 | 741 |
| Prepaid expenses and other assets | 233 | 154 |
| Total assets | <u>\$ 244,050</u> | <u>\$ 235,168</u> |
| Liabilities and Equity | | |
| Other liabilities | \$ 160 | \$ 89 |
| Equity | 243,890 | 235,079 |
| Total liabilities and equity | <u>\$ 244,050</u> | <u>\$ 235,168</u> |

Condensed Statement of Income

| (Dollars in thousands) | For the Year Ended December 31, | |
|---|---------------------------------|------------------|
| | 2019 | 2018 |
| Interest and dividend income: | | |
| Dividends from Territorial Savings Bank | \$ 21,250 | \$ 14,500 |
| Interest-earning deposit with Territorial Savings Bank | 35 | 43 |
| Total interest and dividend income | 21,285 | 14,543 |
| Noninterest expense: | | |
| Salaries | 43 | 38 |
| Other general and administrative expenses | 676 | 791 |
| Total noninterest expense | 719 | 829 |
| Income before income taxes and equity in undistributed earnings in subsidiaries | 20,566 | 13,714 |
| Income taxes | (177) | (107) |
| Income before equity in undistributed earnings in subsidiaries | 20,743 | 13,821 |
| Equity in undistributed earnings of Territorial Savings Bank, net of dividends | 1,252 | 5,391 |
| Net income | <u>\$ 21,995</u> | <u>\$ 19,212</u> |

Condensed Statement of Cash Flows

| (Dollars in thousands) | For the Year Ended December 31, | |
|---|---------------------------------|-----------|
| | 2019 | 2018 |
| Cash flows from operating activities: | | |
| Net income | \$ 21,995 | \$ 19,212 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Equity in undistributed earnings of Territorial Savings Bank, net of dividends | (1,252) | (5,391) |
| ESOP expense | 1,398 | 1,456 |
| Net (increase) decrease in prepaid expenses and other assets | (715) | 785 |
| Net increase (decrease) in other liabilities | (97) | (6) |
| Net cash provided by operating activities | 21,329 | 16,056 |
| Cash flows from investing activities: | | |
| Investment in Territorial Savings Bank | — | — |
| Net cash used in investing activities | — | — |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 170 | — |
| Repurchases of common stock | (1,597) | (9,270) |
| Cash dividends paid | (13,689) | (10,490) |
| Net cash used in financing activities | (15,116) | (19,760) |
| Net increase (decrease) in cash | 6,213 | (3,704) |
| Cash at beginning of the period | 16,389 | 20,093 |
| Cash at end of the period | \$ 22,602 | \$ 16,389 |

(29) Unaudited Quarterly Financial Information

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year |
|---|---|-------------------|------------------|-------------------|-----------|
| | (Dollars in thousands, except per share data) | | | | |
| 2019: | | | | | |
| Interest income | \$ 18,705 | \$ 19,114 | \$ 18,948 | \$ 18,801 | \$ 75,568 |
| Interest expense | 3,869 | 4,452 | 4,397 | 4,309 | 17,027 |
| Net interest income | 14,836 | 14,662 | 14,551 | 14,492 | 58,541 |
| Provision (reversal of provision) for loan losses | 5 | (51) | 111 | (4) | 61 |
| Net interest income after provision for loan losses | 14,831 | 14,713 | 14,440 | 14,496 | 58,480 |
| Noninterest income | 3,440 | 1,273 | 2,102 | 1,017 | 7,832 |
| Noninterest expense | 9,774 | 9,511 | 9,401 | 9,320 | 38,006 |
| Income before income taxes | 8,497 | 6,475 | 7,141 | 6,193 | 28,306 |
| Income taxes | 1,973 | 1,415 | 1,775 | 1,148 | 6,311 |
| Net income | 6,524 | 5,060 | 5,366 | 5,045 | 21,995 |
| Basic earnings per share | 0.71 | 0.55 | 0.58 | 0.54 | 2.38 |
| Diluted earnings per share | 0.70 | 0.54 | 0.57 | 0.53 | 2.34 |
| Cash dividends declared per common share | 0.22 | 0.32 | 0.22 | 0.73 | 1.49 |

| | <u>First Quarter</u> | <u>Second Quarter</u> | <u>Third Quarter</u> | <u>Fourth Quarter</u> | <u>Full Year</u> |
|---|---|---------------------------|--------------------------|---------------------------|------------------|
| | (Dollars in thousands, except per share data) | | | | |
| 2018: | | | | | |
| Interest income | \$ 18,234 | \$ 18,182 | \$ 18,278 | \$ 18,607 | \$ 73,301 |
| Interest expense | 2,995 | 3,275 | 3,517 | 3,742 | 13,529 |
| Net interest income | 15,239 | 14,907 | 14,761 | 14,865 | 59,772 |
| Provision (reversal of provision) for loan losses | 9 | 60 | (50) | 100 | 119 |
| Net interest income after provision for loan losses | 15,230 | 14,847 | 14,811 | 14,765 | 59,653 |
| Noninterest income | 742 | 837 | 746 | 839 | 3,164 |
| Noninterest expense | 9,393 | 9,374 | 9,503 | 9,224 | 37,494 |
| Income before income taxes | 6,579 | 6,310 | 6,054 | 6,380 | 25,323 |
| Income taxes | 1,759 | 1,347 | 1,268 | 1,737 | 6,111 |
| Net income | 4,820 | 4,963 | 4,786 | 4,643 | 19,212 |
| Basic earnings per share | 0.52 | 0.54 | 0.52 | 0.50 | 2.07 |
| Diluted earnings per share | 0.51 | 0.53 | 0.51 | 0.50 | 2.03 |
| Cash dividends declared per common share | 0.20 | 0.30 | 0.22 | 0.42 | 1.14 |

(30) Subsequent Events

On January 30, 2020, the Board of Directors of Territorial Bancorp Inc. declared a quarterly cash dividend of \$0.23 per share of common stock. The dividend was paid on February 27, 2020 to stockholders of record as of February 13, 2020.

ITEM 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None.

ITEM 9A. Controls and Procedures

(a) An evaluation was performed under the supervision and with the participation of the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of December 31, 2019. Based on that evaluation, the Company's management, including the Chairman of the Board, President and Chief Executive Officer and the Senior Vice President and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective.

During the quarter ended December 31, 2019, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

(b) Management's annual report on internal control over financial reporting.

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting as such term is defined in Rule 13a-15(f) in the Exchange Act. The Company's internal control system is a process designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation and fair presentation of published financial statements.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on our financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2019. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control-Integrated Framework (2013). Based on our assessment we believe that, as of December 31, 2019, the Company's internal control over financial reporting is effective based on those criteria.

The Company's independent registered public accounting firm that audited the Consolidated Financial Statements has issued an audit report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2019, and it is included in Item 8, under Part II of this Annual Report on Form 10-K.

ITEM 9B. Other Information

None.

PART III

ITEM 10. Directors, Executive Officers and Corporate Governance

The information in Territorial Bancorp Inc.'s definitive Proxy Statement for the 2020 Annual Meeting of Stockholders under the captions "Proposal 1—Election of Directors," "Information About Executive Officers," "Delinquent Section 16(a) Reports," "Corporate Governance - Code of Ethics and Business Conduct," "Nominating and Corporate Governance Committee Procedures—Procedures to be Followed by Stockholders," "Corporate Governance - Committees of the Board of Directors" and "—Audit Committee" is incorporated herein by reference.

ITEM 11. Executive Compensation

The information in Territorial Bancorp Inc.'s definitive Proxy Statement for the 2020 Annual Meeting of Stockholders under the caption "Executive Compensation" is incorporated herein by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information in Territorial Bancorp Inc.'s definitive Proxy Statement for the 2020 Annual Meeting of Stockholders under the caption "Stock Ownership" is incorporated herein by reference. Information with respect to the security ownership of our directors and executive officers is included above in "Item 10. Directors, Executive Officers and Corporate Governance," and is incorporated herein by reference.

Equity Compensation Plan Information

Set forth below is information as of December 31, 2019 with respect to compensation plans (other than our employee stock ownership plan) under which equity securities of the Registrant are authorized for issuance.

Equity Compensation Plan Information

| | Number of Securities to Be Issued Upon Exercise of Outstanding Options, Warrants and Rights | Weighted-average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Share-based Compensation Plans (excluding securities reflected in first column) |
|--|---|---|--|
| Equity compensation plans approved by security holders (1) | 116,409 | \$ 17.53 | 195,628 |

(1) Reflects stock options only

ITEM 13. Certain Relationships and Related Transactions, and Director Independence

The information in Territorial Bancorp Inc.'s definitive Proxy Statement for the 2020 Annual Meeting of Stockholders under the captions "Transactions with Certain Related Persons" and "Proposal 1 — Election of Directors" is incorporated herein by reference.

ITEM 14. Principal Accountant Fees and Services

The information in Territorial Bancorp Inc.'s definitive Proxy Statement for the 2020 Annual Meeting of Stockholders under the captions "Proposal 2—Ratification of Independent Registered Public Accounting Firm—Audit Fees" and "—Pre-Approval of Services by the Independent Registered Public Accounting Firm" is incorporated herein by reference.

PART IV

ITEM 15. Exhibits and Financial Statement Schedules

(a) *Financial Statements*

The following documents are filed as part of this annual report:

- (i) Reports of Independent Registered Public Accounting Firms
- (ii) Consolidated Balance Sheets at December 31, 2019 and 2018
- (iii) Consolidated Statements of Income for the years ended December 31, 2019 and 2018
- (iv) Consolidated Statements of Comprehensive Income for the years ended December 31, 2019 and 2018
- (v) Consolidated Statements of Stockholders' Equity for the years ended December 31, 2019 and 2018
- (vi) Consolidated Statements of Cash Flows for the years ended December 31, 2019 and 2018
- (vii) Notes to Consolidated Financial Statements

(b) *Exhibits*

- 3.1 Articles of Incorporation of Territorial Bancorp Inc. (1)
- 3.2 Bylaws of Territorial Bancorp Inc. (1)
- 4.1 Form of Common Stock Certificate of Territorial Bancorp Inc. (1)
- 4.2 Description of Registrant's Securities
- 10.1 Employment Agreement between Territorial Bancorp Inc. and Allan S. Kitagawa (2)
- 10.2 Employment Agreement between Territorial Savings Bank and Allan S. Kitagawa (1)
- 10.3 First Amendment to Employment Agreement between Territorial Savings Bank and Allan S. Kitagawa (4)
- 10.4 Employment Agreement between Territorial Bancorp Inc. and Vernon Hirata (2)
- 10.5 Employment Agreement between Territorial Savings Bank and Vernon Hirata (1)
- 10.6 First Amendment to Employment Agreement between Territorial Savings Bank and Vernon Hirata (4)
- 10.7 Employment Agreement between Territorial Bancorp Inc. and Ralph Y. Nakatsuka (2)
- 10.8 Employment Agreement between Territorial Savings Bank and Ralph Y. Nakatsuka (1)
- 10.9 First Amendment to Employment Agreement between Territorial Savings Bank and Ralph Y. Nakatsuka (4)
- 10.10 Supplemental Executive Retirement Agreement between Territorial Savings Bank and Allan S. Kitagawa (1)
- 10.11 Supplemental Executive Retirement Agreement between Territorial Savings Bank and Vernon Hirata (1)
- 10.12 Supplemental Executive Retirement Agreement between Territorial Savings Bank and Ralph Y. Nakatsuka (1)
- 10.13 Executive Deferred Incentive Agreement between Territorial Savings Bank and Allan S. Kitagawa (1)
- 10.14 Executive Deferred Incentive Agreement between Territorial Savings Bank and Vernon Hirata (1)
- 10.15 [Intentionally omitted]
- 10.16 Territorial Savings Bank Non-Qualified Supplemental Employee Stock Ownership Plan (2)
- 10.17 Territorial Savings Bank Executive Incentive Compensation Plan (1)
- 10.18 First Amendment to Territorial Savings Bank Executive Incentive Compensation Plan (1)
- 10.19 Second Amendment to Territorial Savings Bank Executive Incentive Compensation Plan (4)
- 10.20 [Intentionally Omitted]
- 10.21 Form of Employee Restricted Stock Award (4)
- 10.22 Form of Employee Stock Option Award (4)
- 10.23 Form of Director Restricted Stock Award (4)
- 10.24 Form of Director Stock Option Award (4)
- 10.25 Territorial Savings Bank Separation Pay Plan and Summary Plan Description (1)
- 10.26 Amendment One to Territorial Savings Bank Amended and Restated Supplemental Employee Retirement Agreement for Vernon Hirata (5)
- 10.27 Amendment One to Territorial Savings Bank Amended and Restated Supplemental Employee Retirement Agreement for Ralph Nakatsuka (5)
- 10.28 [Intentionally Omitted]

| | |
|---------|---|
| 10.29 | Amendment Two to Territorial Savings Bank Amended and Restated Supplemental Employee Retirement Agreement for Vernon Hirata (6) |
| 10.30 | Amendment Two to Territorial Savings Bank Amended and Restated Supplemental Employee Retirement Agreement for Ralph Nakatsuka (6) |
| 10.31 | Second Amendment to Employment Agreement between Territorial Savings Bank and Vernon Hirata (7) |
| 10.32 | Third Amendment to Employment Agreement between Territorial Savings Bank and Vernon Hirata (8) |
| 10.33 | First Amendment to Employment Agreement between Territorial Bancorp Inc. and Vernon Hirata (8) |
| 10.34 | Second Amendment to Employment Agreement between Territorial Savings Bank and Allan S. Kitagawa (8) |
| 10.35 | First Amendment to Employment Agreement between Territorial Bancorp Inc. and Allan S. Kitagawa (8) |
| 10.36 | Second Amendment to Employment Agreement between Territorial Savings Bank and Ralph Nakatsuka (8) |
| 10.37 | First Amendment to Employment Agreement between Territorial Bancorp Inc. and Ralph Nakatsuka (8) |
| 10.38 | First Amendment to Amended and Restated Executive Deferred Incentive Agreement between Territorial Savings Bank and Vernon Hirata (8) |
| 10.39 | First Amendment to Amended and Restated Supplemental Employee Retirement Agreement between Territorial Savings Bank and Allan S. Kitagawa (8) |
| 10.40 | Third Amendment to Amended and Restated Supplemental Employee Retirement Agreement between Territorial Savings Bank and Vernon Hirata (8) |
| 10.41 | Third Amendment to Amended and Restated Supplemental Employee Retirement Agreement between Territorial Savings Bank and Ralph Nakatsuka (8) |
| 10.42 | Territorial Bancorp Inc. 2010 Equity Incentive Plan, as amended and restated (9) |
| 10.43 | Territorial Bancorp Inc. Annual Incentive Plan, as amended (10) |
| 10.44 | Territorial Bancorp Inc. 2019 Equity Incentive Plan (11) |
| 23 | Consent of Moss Adams LLP |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | The following financial statements from Territorial Bancorp Inc.'s Annual Report on Form 10-K for the year ended December 31, 2019, filed on March 13, 2020, formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Stockholders' Equity, (v) Consolidated Statements of Cash Flows, (vi) the Notes to Consolidated Financial Statements. |
| 101.INS | Interactive datafile XBRL Instance Document |
| 101.SCH | Interactive datafile XBRL Taxonomy Extension Schema Document |
| 101.CAL | Interactive datafile XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | Interactive datafile XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | Interactive datafile XBRL Taxonomy Extension Label Linkbase |
| 101.PRE | Interactive datafile XBRL Taxonomy Extension Presentation Linkbase Document |

-
- (1) Incorporated by reference to the Registration Statement on Form S-1 (file no. 333-155388), initially filed November 14, 2008.
 - (2) Incorporated by reference to the Current Report on Form 8-K (file no. 001-34403), filed November 18, 2009.
 - (3) Incorporated by reference to the Proxy Statement for the 2010 Annual Meeting of Stockholders (file no. 001-34403), filed July 12, 2010.
 - (4) Incorporated by reference to the Annual Report on Form 10-K/A (file no. 001-34403), filed March 29, 2011.
 - (5) Incorporated by reference to the Annual Report on Form 10-Q (file no. 001-34403), filed May 14, 2011.
 - (6) Incorporated by reference to the Annual Report on Form 10-K (file no. 001-34403), filed March 14, 2012.
 - (7) Incorporated by reference to the Annual Report on Form 10-K (file no. 001-34403), filed March 15, 2013.
 - (8) Incorporated by reference to the Quarterly Report on Form 10-Q (file no. 001-34403), filed November 7, 2014.
 - (9) Incorporated by reference to Appendix A to the proxy statement for the Annual Meeting of Shareholders (file No. 001-34403), filed April 24, 2017.

- (10) Incorporated by reference to Appendix B to the proxy statement for the Annual Meeting of Stockholders (file No. 001-34403), filed April 24, 2017.
- (11) Incorporated by reference to Appendix A to the proxy statement for the 2019 Annual Meeting of Stockholders (file No. 001-34403), filed April 16, 2019.

(c) *Financial Statement Schedules*

Not applicable.

ITEM 16. Form 10-K Summary

Not applicable.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TERRITORIAL BANCORP INC.

Date: March 13, 2020

By: /s/ Allan S. Kitagawa

Allan S. Kitagawa

Chairman of the Board, President and Chief

Executive Officer

(Duly Authorized Representative)

Pursuant to requirements of the Exchange Act, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| <u>Signatures</u> | <u>Title</u> | <u>Date</u> |
|---|---|----------------|
| <u>/s/ Allan S. Kitagawa</u> Allan S. Kitagawa | Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer) | March 13, 2020 |
| <u>/s/ Melvin M. Miyamoto</u> Melvin M. Miyamoto | Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer) | March 13, 2020 |
| <u>/s/ Kirk W. Caldwell</u> Kirk W. Caldwell | Director | March 13, 2020 |
| <u>/s/ Howard Y. Ikeda</u> Howard Y. Ikeda | Director | March 13, 2020 |
| <u>/s/ Jennifer A. Isobe</u> Jennifer A. Isobe | Director | March 13, 2020 |
| <u>/s/ David S. Murakami</u> David S. Murakami | Director | March 13, 2020 |
| <u>/s/ John M. Ohama</u> John M. Ohama | Director | March 13, 2020 |
| <u>/s/ Francis E. Tanaka</u> Francis E. Tanaka | Director | March 13, 2020 |



Kauai Branch

CORPORATE OFFICE

1132 Bishop Street, Suite 2200
Honolulu, Hawaii 96813

Aina Haina Branch

820 W. Hind Drive, Suite 118
Honolulu, Hawaii 96821

Ala Moana Center Branch

Street Level, Mauka
1450 Ala Moana Boulevard, Suite 1052
Honolulu, Hawaii 96814

Downtown Branch

1000 Bishop Street
Honolulu, Hawaii 96813

Hawaii Kai Branch

Hawaii Kai Shopping Center
377 Keahole Street
Honolulu, Hawaii 96825

Hilo Branch

Waiakea Center
315 Makaala Street, Suite 102
Hilo, Hawaii 96720

Kahala Branch

4819 Kilauea Avenue, Suite 4
Honolulu, Hawaii 96816

Kahului Branch

Queen Kaahumanu Center
275 W. Kaahumanu Avenue, Suite 1045A
Kahului, Maui, Hawaii 96732

Kailua Branch

19 Oneawa Street
Kailua, Hawaii 96734

Kaimuki Branch

1108 12th Avenue, Suite C
Honolulu, Hawaii 96816

Kalihi-Kapalama Branch

1199 Dillingham Boulevard
Honolulu, Hawaii 96817

Kamehameha Shopping Center Branch

1620 North School Street, Suite 136
Honolulu, Hawaii 96817



Territorial Bancorp Inc.



Honolulu

Kaneohe Branch

46-005 Kawa Street, Suite 102
Kaneohe, Hawaii 96744

Kapahulu Branch

Kilohana Square
1016 Kapahulu Avenue, Suite 130
Honolulu, Hawaii 96816

Kapolei Branch

Ace Center of Kapolei
480 Kamokila Boulevard, Suite 105
Kapolei, Hawaii 96709

Kauai Branch

Kukui Grove Shopping Center
4393 Kukui Grove Street, Suite 103
Lihue, Kauai, Hawaii 96766

Keeaumoku Branch

735 Keeaumoku Street, Suite 108
Honolulu, Hawaii 96814

Kihei Branch

Azeka Shopping Center Mauka
1279 South Kihei Road, Suite 311
Kihei, Hawaii 96753

Kona Branch

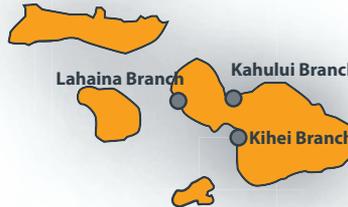
Crossroads Shopping Center
75-1027 Henry Street, Suite 111B
Kailua-Kona, Hawaii 96740

Lahaina Branch

Old Lahaina Center
170 Papalaua Street, Unit 3
Lahaina, Hawaii 96761

Manoa Branch

2752 Woodlawn Drive, #5-110
Honolulu, Hawaii 96822



Lahaina Branch

Kahului Branch

Kihei Branch

McCully Branch

1111 McCully Street
Honolulu, Hawaii 96826

Mililani Branch

Town Center of Mililani
95-1249 Meheula Park Way, Suite 168
Mililani, Hawaii 96789

Nuuanu Branch

Nuuanu Shopping Center
1613 Nuuanu Avenue, Suite A15
Honolulu, Hawaii 96817

Pearl City Branch

Pearl City Shopping Center
850 Kamehameha Highway, Suite B2
Pearl City, Hawaii 96782

Pearlridge Branch

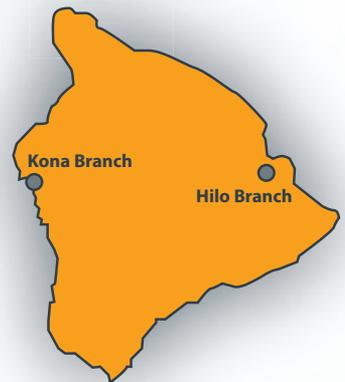
98-084 Kamehameha Highway
Aiea, Hawaii 96701

Piikoi Branch

1159 S. Beretania Street
Honolulu, Hawaii 96814

Salt Lake Branch

Salt Lake Shopping Center
848 Ala Liliko'i Street, Suite 107
Honolulu, Hawaii 96818



Kona Branch

Hilo Branch

Waipahu Branch

Waipahu Town Center
94-050 Farrington Highway
Waipahu, Hawaii 96797

Waipio Branch

Laniakea Plaza
94-1221 Ka Uka Boulevard, #102
Waipahu, Hawaii 96797

