TFS Financial CORP
Form 10-Q
August 07, 2017
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2017
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For transition period from to
Commission File Number 001-33390

TFS FINANCIAL CORPORATION
(Exact Name of Registrant as Specified in its Charter)

United States of America (State or Other Jurisdiction of Incorporation or Organization)	52-2054948 (I.R.S. Employer Identification No.)
7007 Broadway Avenue Cleveland, Ohio	44105
(Address of Principal Executive Offices)	(Zip Code)

(216) 441-6000
Registrant’s telephone number, including area code:
Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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. (Check one):

Large accelerated filer	x	Accelerated filer	¨

Non-accelerated filer ¨ (do not check if a smaller reporting company) Smaller Reporting Company ¨

Emerging Growth Company o
If an emerging 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. o
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x.

As of August 3, 2017, there were 281,445,875 shares of the Registrant’s common stock, par value $0.01 per share, outstanding, of which 227,119,132 shares, or 80.7% of the Registrant’s common stock, were held by Third Federal Savings and Loan Association of Cleveland, MHC, the Registrant’s mutual holding company.

Table of Contents

TFS Financial Corporation
INDEX

		Page
	Glossary of Terms	3
PART I – FINANCIAL INFORMATION		
Item 1.	Financial Statements (unaudited)	
	Consolidated Statements of Condition June 30, 2017 and September 30, 2016	4
	Consolidated Statements of Income Three and Nine Months Ended June 30, 2017 and 2016	5
	Consolidated Statements of Comprehensive Income Three and Nine Months Ended June 30, 2017 and 2016	6
	Consolidated Statements of Shareholders' Equity Nine Months Ended June 30, 2017 and 2016	7
	Consolidated Statements of Cash Flows Nine Months Ended June 30, 2017 and 2016	8
	Notes to Unaudited Interim Consolidated Financial Statements	9
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	37
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	70
Item 4.	Controls and Procedures	74
Part II — OTHER INFORMATION		
Item 1.	Legal Proceedings	74
Item 1A.	Risk Factors	74
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	75
Item 3.	Defaults Upon Senior Securities	75
Item 4.	Mine Safety Disclosures	75
Item 5.	Other Information	75
Item 6.	Exhibits	76

SIGNATURES 77

2

Table of Contents

GLOSSARY OF TERMS

TFS Financial Corporation provides the following list of acronyms and defined terms as a tool for the reader. The acronyms and defined terms identified below are used throughout the document.

AOCI: Accumulated Other Comprehensive Income
ARM: Adjustable Rate Mortgage
ASC: Accounting Standards Codification
ASU: Accounting Standards Update
Association: Third Federal Savings and Loan Association of Cleveland
BOLI: Bank Owned Life Insurance
CDs: Certificates of Deposit
CFPB: Consumer Financial Protection Bureau
CLTV: Combined Loan-to-Value
Company: TFS Financial Corporation and its subsidiaries
DFA: Dodd-Frank Wall Street Reform and Consumer Protection Act
DIF: Depository Insurance Fund
EaR: Earnings at Risk
EPS: Earnings per Share
ESOP: Third Federal Employee (Associate) Stock Ownership Plan
EVE: Economic Value of Equity
Fannie Mae: Federal National Mortgage Association
FASB: Financial Accounting Standards Board
FDIC: Federal Deposit Insurance Corporation
FHFA: Federal Housing Finance Agency
FHLB: Federal Home Loan Bank
FICO: Financing Corporation
FRB-Cleveland: Federal Reserve Bank of Cleveland
Freddie Mac: Federal Home Loan Mortgage Association
FRS: Board of Governors of the Federal Reserve System
GAAP: Generally Accepted Accounting Principles
Ginnie Mae: Government National Mortgage Association
GVA: General Valuation Allowances
HARP: Home Affordable Refinance Program
HPI: Home Price Index
IRR: Interest Rate Risk
IRS: Internal Revenue Service
IVA: Individual Valuation Allowance
LIHTC: Low Income Housing Tax Credit
LIP: Loans-in-Process
LTV: Loan-to-Value
MGIC: Mortgage Guaranty Insurance Corporation
OCC: Office of the Comptroller of the Currency
OCI: Other Comprehensive Income
OTS: Office of Thrift Supervision
PMIC: PMI Mortgage Insurance Co.
QTL: Qualified Thrift Lender
REMICs: Real Estate Mortgage Investment Conduits
SVA: Specific Valuation Allowance
SEC: United States Securities and Exchange Commission
TDR: Troubled Debt Restructuring
Third Federal Savings, MHC: Third Federal Savings and Loan Association of Cleveland, MHC

Table of Contents

Item 1. Financial Statements
TFS FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CONDITION (unaudited)
(In thousands, except share data)

	June 30, 2017	September 30, 2016
ASSETS		
Cash and due from banks	$30,045	$27,914
Interest-earning cash equivalents	234,854	203,325
Cash and cash equivalents	264,899	231,239
Investment securities available for sale (amortized cost $533,385 and $517,228, respectively)	529,579	517,866
Mortgage loans held for sale, at lower of cost or market (none measured at fair value)	803	4,686
Loans held for investment, net:		
Mortgage loans	12,288,086	11,748,099
Other consumer loans	2,957	3,116
Deferred loan expenses, net	28,859	19,384
Allowance for loan losses	(54,930)	(61,795)
Loans, net	12,264,972	11,708,804
Mortgage loan servicing rights, net	8,625	8,852
Federal Home Loan Bank stock, at cost	87,110	69,853
Real estate owned	5,524	6,803
Premises, equipment, and software, net	58,350	61,003
Accrued interest receivable	34,607	32,818
Bank owned life insurance contracts	204,294	200,144
Other assets	66,816	63,994
TOTAL ASSETS	$13,525,579	$12,906,062
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits	$8,175,859	$8,331,368
Borrowed funds	3,542,772	2,718,795
Borrowers' advances for insurance and taxes	55,864	92,313
Principal, interest, and related escrow owed on loans serviced	25,469	49,401
Accrued expenses and other liabilities	47,991	53,727
Total liabilities	11,847,955	11,245,604
Commitments and contingent liabilities		
Preferred stock, $0.01 par value, 100,000,000 shares authorized, none issued and outstanding	—	—
Common stock, $0.01 par value, 700,000,000 shares authorized; 332,318,750 shares issued; 281,872,724 and 284,219,019 outstanding at June 30, 2017 and September 30, 2016, respectively	3,323	3,323
Paid-in capital	1,721,153	1,716,818
Treasury stock, at cost; 50,446,026 and 48,099,731 shares at June 30, 2017 and September 30, 2016, respectively	(726,396)	(681,569)
Unallocated ESOP shares	(54,168)	(57,418)
Retained earnings—substantially restricted	745,513	698,930
Accumulated other comprehensive loss	(11,801)	(19,626)
Total shareholders' equity	1,677,624	1,660,458
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$13,525,579	$12,906,062

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents

TFS FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (unaudited)
(In thousands, except share and per share data)

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2017	2016	2017	2016
INTEREST AND DIVIDEND INCOME:				
Loans, including fees	$99,699	$ 93,752	$292,755	$ 280,663
Investment securities available for sale	2,522	2,374	6,573	7,407
Other interest and dividend earning assets	1,500	867	3,690	2,499
Total interest and dividend income	103,721	96,993	303,018	290,569
INTEREST EXPENSE:				
Deposits	21,831	22,543	65,208	67,333
Borrowed funds	11,618	7,061	29,022	20,447
Total interest expense	33,449	29,604	94,230	87,780
NET INTEREST INCOME	70,272	67,389	208,788	202,789
PROVISION (CREDIT) FOR LOAN LOSSES	(4,000)	(3,000)	(10,000)	(5,000)
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	74,272	70,389	218,788	207,789
NON-INTEREST INCOME:				
Fees and service charges, net of amortization	1,714	1,729	5,163	5,524
Net gain on the sale of loans	259	1,834	1,472	4,576
Increase in and death benefits from bank owned life insurance contracts	1,703	1,612	4,866	5,796
Other	1,128	933	3,223	3,032
Total non-interest income	4,804	6,108	14,724	18,928
NON-INTEREST EXPENSE:				
Salaries and employee benefits	23,735	23,055	71,965	73,057
Marketing services	5,183	4,499	14,509	13,151
Office property, equipment and software	5,985	5,924	17,969	17,626
Federal insurance premium and assessments	2,531	2,393	7,467	8,216
State franchise tax	1,318	1,240	3,989	4,132
Real estate owned expense, net	376	1,826	2,256	5,700
Other operating expenses	5,541	6,039	17,070	17,068
Total non-interest expense	44,669	44,976	135,225	138,950
INCOME BEFORE INCOME TAXES	34,407	31,521	98,287	87,767
INCOME TAX EXPENSE	11,619	10,901	32,428	30,020
NET INCOME	$22,788	$ 20,620	$65,859	$ 57,747
Earnings per share—basic and diluted	$0.08	$ 0.07	$0.23	$ 0.20
Weighted average shares outstanding				
Basic	277,056,49[illegible]	280,815,430	277,590,340	282,326,922
Diluted	278,986,397	283,011,869	279,719,537	284,602,870

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents

TFS FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)
(In thousands)

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2017	2016	2017	2016
Net income	$22,788	$20,620	$65,859	$57,747
Other comprehensive income (loss), net of tax:				
Net change in unrealized gain (loss) on securities available for sale	2,446	1,025	(2,889)	317
Net change in cash flow hedges	(3,199)	(2,672)	9,678	(4,317)
Change in pension obligation	345	251	1,036	752
Total other comprehensive income (loss)	(408)	(1,396)	7,825	(3,248)
Total comprehensive income	$22,380	$19,224	$73,684	$54,499

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents

TFS FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (unaudited)
(In thousands, except share and per share data)

	Common stock	Paid-in capital	Treasury stock	Unallocated common stock held by ESOP	Retained earnings	Accumulated other comprehensive income (loss)	Total shareholders' equity
Balance at September 30, 2015	$ 3,323	$ 1,707,629	$ (548,557)	$ (61,751)	$ 641,791	$ (13,065)	$ 1,729,370
Net income	—	—	—	—	57,747	—	57,747
Other comprehensive loss, net of tax	—	—	—	—	—	(3,248)	(3,248)
ESOP shares allocated or committed to be released	—	2,519	—	3,250	—	—	5,769
Compensation costs for stock-based plans	—	4,710	—	—	—	—	4,710
Excess tax effect from stock-based compensation	—	2,695	—	—	—	—	2,695
Purchase of treasury stock (5,333,000 shares)	—	—	(94,649)	—	—	—	(94,649)
Treasury stock allocated to restricted stock plan	—	(3,029)	(3,556)	—	—	—	(6,585)
Dividends paid to common shareholders ($0.30 per common share)	—	—	—	—	(16,811)	—	(16,811)
Balance at June 30, 2016	$ 3,323	$ 1,714,524	$ (646,762)	$ (58,501)	$ 682,727	$ (16,313)	$ 1,678,998
Balance at September 30, 2016	$ 3,323	$ 1,716,818	$ (681,569)	$ (57,418)	$ 698,930	$ (19,626)	$ 1,660,458
Net income	—	—	—	—	65,859	—	65,859
Other comprehensive income, net of tax	—	—	—	—	—	7,825	7,825
ESOP shares allocated or committed to be released	—	2,398	—	3,250	—	—	5,648
Compensation costs for stock-based plans	—	3,004	—	—	(29)	—	2,975
Purchase of treasury stock (2,561,710 shares)	—	—	(43,349)	—	—	—	(43,349)
Treasury stock allocated to restricted stock plan	—	(1,067)	(1,478)	—	—	—	(2,545)
Dividends paid to common shareholders ($0.375 per common share)	—	—	—	—	(19,247)	—	(19,247)
Balance at June 30, 2017	$ 3,323	$ 1,721,153	$ (726,396)	$ (54,168)	$ 745,513	$ (11,801)	$ 1,677,624

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents

TFS FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited) (in thousands)

	For the Nine Months Ended June 30, 2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$65,859	$57,747
Adjustments to reconcile net income to net cash provided by operating activities:		
ESOP and stock-based compensation expense	8,623	10,479
Depreciation and amortization	16,542	14,008
Deferred income tax (benefit) expense	(117)	38
Provision for loan losses	(10,000)	(5,000)
Net gain on the sale of loans	(1,472)	(4,576)
Other net losses	253	1,229
Principal repayments on and proceeds from sales of loans held for sale	23,491	12,164
Loans originated for sale	(19,831)	(12,118)
Increase in bank owned life insurance contracts	(4,731)	(3,243)
Cash collateral received from derivative counterparties	6,043	—
Net increase in interest receivable and other assets	(701)	(12,049)
Net decrease in accrued expenses and other liabilities	(2,605)	(3,878)
Other	—	162
Net cash provided by operating activities	81,354	54,963
CASH FLOWS FROM INVESTING ACTIVITIES:		
Loans originated	(2,632,204)	(2,018,772)
Principal repayments on loans	1,878,296	1,619,065
Proceeds from principal repayments and maturities of:		
Securities available for sale	116,871	110,859
Proceeds from sale of:		
Loans	195,756	140,854
Real estate owned	6,657	16,898
Purchases of:		
FHLB stock	(17,257)	(383)
Securities available for sale	(137,272)	(59,523)
Premises and equipment	(1,339)	(7,479)
Other	530	583
Net cash used in investing activities	(589,962)	(197,898)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (decrease) increase in deposits	(155,509)	83,042
Net decrease in borrowers' advances for insurance and taxes	(36,449)	(38,143)
Net decrease in principal and interest owed on loans serviced	(23,932)	(14,908)
Net increase in short-term borrowed funds	210,244	413,161
Proceeds from long-term borrowed funds	700,000	40,290
Repayment of long-term borrowed funds	(86,267)	(179,186)
Purchase of treasury shares	(44,027)	(94,676)
Excess tax benefit related to stock-based compensation	—	2,695
Acquisition of treasury shares through net settlement of stock benefit plans compensation	(2,545)	(6,585)
Dividends paid to common shareholders	(19,247)	(16,811)

Net cash provided by financing activities	542,268	188,879
NET INCREASE IN CASH AND CASH EQUIVALENTS	33,660	45,944
CASH AND CASH EQUIVALENTS—Beginning of period	231,239	155,369
CASH AND CASH EQUIVALENTS—End of period	$264,899	$201,313
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest on deposits	$65,168	$67,173
Cash paid for interest on borrowed funds	24,316	19,392
Cash paid for income taxes	30,955	25,782
SUPPLEMENTAL SCHEDULES OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Transfer of loans to real estate owned	5,597	9,722
Transfer of loans from held for investment to held for sale	196,540	138,253
Treasury stock issued for stock benefit plans	1,067	3,029

See accompanying notes to unaudited interim consolidated financial statements.

8

TFS FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands unless otherwise indicated)

1. BASIS OF PRESENTATION

TFS Financial Corporation, a federally chartered stock holding company, conducts its principal activities through its wholly owned subsidiaries. The principal line of business of the Company is retail consumer banking, including mortgage lending, deposit gathering, and, to a much lesser extent, other financial services. As of June 30, 2017, approximately 81% of the Company's outstanding shares were owned by a federally chartered mutual holding company, Third Federal Savings and Loan Association of Cleveland, MHC. The thrift subsidiary of TFS Financial Corporation is Third Federal Savings and Loan Association of Cleveland.

The accounting and reporting policies followed by the Company conform in all material respects to U.S. GAAP and to general practices in the financial services industry. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. The allowance for loan losses, the valuation of deferred tax assets, and the determination of pension obligations are particularly subject to change.

The unaudited interim consolidated financial statements were prepared without an audit and reflect all adjustments of a normal recurring nature which, in the opinion of management, are necessary to present fairly the consolidated financial condition of the Company at June 30, 2017, and its results of operations and cash flows for the periods presented. Such adjustments are the only adjustments reflected in the unaudited interim financial statements. In accordance with SEC Regulation S-X for interim financial information, these statements do not include certain information and footnote disclosures required for complete audited financial statements. The Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2016 contains consolidated financial statements and related notes, which should be read in conjunction with the accompanying interim consolidated financial statements. The results of operations for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2017 or for any other period.

2. EARNINGS PER SHARE

Basic earnings per share is the amount of earnings available to each share of common stock outstanding during the reporting period. Diluted earnings per share is the amount of earnings available to each share of common stock outstanding during the reporting period adjusted to include the effect of potentially dilutive common shares. For purposes of computing earnings per share amounts, outstanding shares include shares held by the public, shares held by the ESOP that have been allocated to participants or committed to be released for allocation to participants, the 227,119,132 shares held by Third Federal Savings, MHC, and, for purposes of computing dilutive earnings per share, stock options and restricted stock units with a dilutive impact. Unvested shares awarded pursuant to the Company's restricted stock plans are treated as participating securities in the computation of EPS pursuant to the two-class method as they contain nonforfeitable rights to dividends. The two-class method is an earnings allocation that determines EPS for each class of common stock and participating security. At June 30, 2017 and 2016, respectively, the ESOP held 5,416,746 and 5,850,086 shares that were neither allocated to participants nor committed to be released to participants.

9

Table of Contents

The following is a summary of the Company's earnings per share calculations.

	For the Three Months Ended June 30,					
	2017			2016		
	Income	Shares	Per share amount	Income	Shares	Per share amount
	(Dollars in thousands, except per share data)					
Net income	$22,788			$20,620		
Less: income allocated to restricted stock units	216			184		
Basic earnings per share:						
Income available to common shareholders	$22,572	277,056,490	$ 0.08	$20,436	280,815,430	$ 0.07
Diluted earnings per share:						
Effect of dilutive potential common shares		1,929,907			2,196,439	
Income available to common shareholders	$22,572	278,986,397	$ 0.08	$20,436	283,011,869	$ 0.07

	For the Nine Months Ended June 30,					
	2017			2016		
	Income	Shares	Per share amount	Income	Shares	Per share amount
	(Dollars in thousands, except per share data)					
Net income	$65,859			$57,747		
Less: income allocated to restricted stock units	641			545		
Basic earnings per share:						
Income available to common shareholders	$65,218	277,590,340	$ 0.23	$57,202	282,326,922	$ 0.20
Diluted earnings per share:						
Effect of dilutive potential common shares		2,129,197			2,275,948	
Income available to common shareholders	$65,218	279,719,537	$ 0.23	$57,202	284,602,870	$ 0.20

The following is a summary of outstanding stock options and restricted stock units that are excluded from the computation of diluted earnings per share because their inclusion would be anti-dilutive.

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2017	2016	2017	2016
Options to purchase shares	1,105,440	393,500	693,900	393,500
Restricted stock units	16,500	—	16,500	—

3. INVESTMENT SECURITIES

Investments available for sale are summarized as follows:

	June 30, 2017			
	Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
REMICs	$524,736	$113	$(4,343)	$520,506
Fannie Mae certificates	8,649	435	(11)	9,073
Total	$533,385	$548	$(4,354)	$529,579

Table of Contents

	September 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
REMICs	$508,044	$1,447	$(1,494)	$507,997
Fannie Mae certificates	9,184	685	—	9,869
Total	$517,228	$2,132	$(1,494)	$517,866

Gross unrealized losses on available for sale securities and the estimated fair value of the related securities, aggregated by the length of time the securities have been in a continuous loss position, at June 30, 2017 and September 30, 2016, were as follows:

	June 30, 2017					
	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Available for sale—						
REMICs	$335,518	$ 2,636	$133,914	$ 1,707	$469,432	$ 4,343
Fannie Mae certificates	4,636	11	—	—	4,636	11
Total	$340,154	$ 2,647	$133,914	$ 1,707	$474,068	$ 4,354

	September 30, 2016					
	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Available for sale—						
REMICs	$210,735	$ 797	$73,361	$ 697	$284,096	$ 1,494

The unrealized losses on investment securities were attributable to interest rate increases. The contractual terms of U.S. government and agency obligations do not permit the issuer to settle the security at a price less than the par value of the investment. The contractual cash flows of mortgage-backed securities are guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. REMICs are issued by or backed by securities issued by these governmental agencies. It is expected that the securities would not be settled at a price substantially less than the amortized cost of the investment. The U.S. Treasury Department established financing agreements in 2008 to ensure Fannie Mae and Freddie Mac meet their obligations to holders of mortgage-backed securities that they have issued or guaranteed.

Since the decline in value is attributable to changes in interest rates and not credit quality and because the Association has neither the intent to sell the securities nor is it more likely than not the Association will be required to sell the securities for the time periods necessary to recover the amortized cost, these investments are not considered other-than-temporarily impaired.

Table of Contents

4. LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans held for investment consist of the following:

	June 30, 2017	September 30, 2016
Real estate loans:		
Residential Core	$10,623,746	$10,069,652
Residential Home Today	112,048	121,938
Home equity loans and lines of credit	1,520,728	1,531,282
Construction	68,721	61,382
Real estate loans	12,325,243	11,784,254
Other consumer loans	2,957	3,116
Add (deduct):		
Deferred loan expenses, net	28,859	19,384
Loans in process ("LIP")	(37,157)	(36,155)
Allowance for loan losses	(54,930)	(61,795)
Loans held for investment, net	$12,264,972	$11,708,804

At June 30, 2017 and September 30, 2016, respectively, $803 and $4,686 of loans were classified as mortgage loans held for sale.

A large concentration of the Company's lending is in Ohio and Florida. As of June 30, 2017 and September 30, 2016, the percentage of aggregate Residential Core, Home Today and Construction loans held in Ohio were 57% and 60%, respectively, and the percentages held in Florida were 16% as of both dates. As of June 30, 2017 and September 30, 2016, home equity loans and lines of credit were concentrated in Ohio (39% as of both dates), Florida (23% and 24%), and California (14% as of both dates).

Home Today began as an affordable housing program targeted to benefit low- and moderate-income home buyers. Through this program the Association provided the majority of loans to borrowers who would not otherwise qualify for the Association's loan products, generally because of low credit scores. Although the credit profiles of borrowers in the Home Today program might be described as sub-prime, Home Today loans generally contain the same features as loans offered to our Residential Core borrowers. Borrowers with a Home Today loan completed financial management education and counseling and were referred to the Association by a sponsoring organization with which the Association partnered as part of the program. Because the Association applied less stringent underwriting and credit standards to the majority of Home Today loans, loans originated under the program have greater credit risk than its traditional residential real estate mortgage loans in the Residential Core portfolio. Effective March 27, 2009, the Home Today underwriting guidelines were changed to be substantially the same as the Association's traditional first mortgage product and the program focused on financial education and down payment assistance. The majority of loans in this program were originated prior to that date and loans are no longer originated under the Home Today program. As of June 30, 2017 and September 30, 2016, the principal balance of Home Today loans originated prior to March 27, 2009 was $108,326 and $118,255, respectively. Since loans are no longer originated under the Home Today program, the Home Today portfolio will continue to decline in balance due to contractual amortization. To supplant the Home Today product and to continue to meet the credit needs of customers and the communities served, during fiscal 2016 the Association began to offer Fannie Mae eligible, Home Ready loans. These loans are originated in accordance with Fannie Mae's underwriting standards. While the Association retains the servicing to these loans, the loans, along with the credit risk associated therewith, are securitized/sold to Fannie Mae. The Association does not offer, and has not offered, loan products frequently considered to be designed to target sub-prime borrowers containing features such as higher fees or higher rates, negative amortization, a loan-to-value ratio greater than 100%, or pay option adjustable-rate mortgages.

Table of Contents

An age analysis of the recorded investment in loan receivables that are past due at June 30, 2017 and September 30, 2016 is summarized in the following tables. When a loan is more than one month past due on its scheduled payments, the loan is considered 30 days or more past due. Balances are adjusted for deferred loan fees or expenses and any applicable loans-in-process.

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total
June 30, 2017						
Real estate loans:						
Residential Core	$6,640	$3,703	$12,017	$22,360	$10,615,953	$10,638,313
Residential Home Today	3,804	1,421	7,377	12,602	98,140	110,742
Home equity loans and lines of credit	4,177	1,642	5,134	10,953	1,525,843	1,536,796
Construction	—	—	—	—	31,094	31,094
Total real estate loans	14,621	6,766	24,528	45,915	12,271,030	12,316,945
Other consumer loans	—	—	—	—	2,957	2,957
Total	$14,621	$6,766	$24,528	$45,915	$12,273,987	$12,319,902

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total
September 30, 2016						
Real estate loans:						
Residential Core	$6,653	$3,157	$15,593	$25,403	$10,054,211	$10,079,614
Residential Home Today	5,271	2,583	7,356	15,210	105,225	120,435
Home equity loans and lines of credit	4,605	1,811	4,932	11,348	1,531,242	1,542,590
Construction	—	—	—	—	24,844	24,844
Total real estate loans	16,529	7,551	27,881	51,961	11,715,522	11,767,483
Other consumer loans	—	—	—	—	3,116	3,116
Total	$16,529	$7,551	$27,881	$51,961	$11,718,638	$11,770,599

At June 30, 2017 and September 30, 2016, real estate loans include $15,178 and $20,047, respectively, of loans that were in the process of foreclosure.

Loans are placed in non-accrual status when they are contractually 90 days or more past due. Loans restructured in TDRs that were in non-accrual status prior to the restructurings remain in non-accrual status for a minimum of six months after restructuring. Loans where the borrowers' sustained ability to repay is not fully supported at the time of modification are placed in non-accrual status for a minimum of twelve months. Additionally, home equity loans and lines of credit where the customer has a severely delinquent first mortgage loan and loans in Chapter 7 bankruptcy status where all borrowers have filed, and not reaffirmed or been dismissed, are placed in non-accrual status.

The recorded investment of loans in non-accrual status is summarized in the following table. Balances are adjusted for deferred loan fees or expenses.

	June 30, 2017	September 30, 2016
Real estate loans:		
Residential Core	$44,941	$ 51,304
Residential Home Today	18,871	19,451
Home equity loans and lines of credit	17,328	19,206

Total non-accrual loans	$81,140	$ 89,961

13

Table of Contents

At June 30, 2017 and September 30, 2016, respectively, the recorded investment in non-accrual loans includes $56,612 and $62,081, which are performing according to the terms of their agreement, of which $36,340 and $40,546 are loans in Chapter 7 bankruptcy status primarily where all borrowers have filed, and have not reaffirmed or been dismissed.

Interest on loans in accrual status, including certain loans individually reviewed for impairment, is recognized in interest income as it accrues, on a daily basis. Accrued interest on loans in non-accrual status is reversed by a charge to interest income and income is subsequently recognized only to the extent cash payments are received. Cash payments on loans in non-accrual status are applied to the oldest scheduled, unpaid payment first. Cash payments on loans with a partial charge-off are applied fully to principal, then to recovery of the charged off amount prior to interest income being recognized. A non-accrual loan is generally returned to accrual status when contractual payments are less than 90 days past due. However, a loan may remain in non-accrual status when collectability is uncertain, such as a TDR that has not met minimum payment requirements, a loan with a partial charge-off, an equity loan or line of credit with a delinquent first mortgage greater than 90 days past due, or a loan in Chapter 7 bankruptcy status where all borrowers have filed, and have not reaffirmed or been dismissed. The number of days past due is determined by the number of scheduled payments that remain unpaid, assuming a period of 30 days between each scheduled payment.

The recorded investment in loan receivables at June 30, 2017 and September 30, 2016 is summarized in the following table. The table provides details of the recorded balances according to the method of evaluation used for determining the allowance for loan losses, distinguishing between determinations made by evaluating individual loans and determinations made by evaluating groups of loans not individually evaluated. Balances of recorded investments are adjusted for deferred loan fees or expenses and any applicable loans-in-process.

	June 30, 2017			September 30, 2016		
	Individually	Collectively	Total	Individually	Collectively	Total
Real estate loans:						
Residential Core	$98,368	$10,539,945	$10,638,313	$107,541	$9,972,073	$10,079,614
Residential Home Today	48,099	62,643	110,742	51,415	69,020	120,435
Home equity loans and lines of credit	38,885	1,497,911	1,536,796	35,894	1,506,696	1,542,590
Construction	—	31,094	31,094	—	24,844	24,844
Total real estate loans	185,352	12,131,593	12,316,945	194,850	11,572,633	11,767,483
Other consumer loans	—	2,957	2,957	—	3,116	3,116
Total	$185,352	$12,134,550	$12,319,902	$194,850	$11,575,749	$11,770,599

An analysis of the allowance for loan losses at June 30, 2017 and September 30, 2016 is summarized in the following table. The analysis provides details of the allowance for loan losses according to the method of evaluation, distinguishing between allowances for loan losses determined by evaluating individual loans and allowances for loan losses determined by evaluating groups of loans collectively.

	June 30, 2017			September 30, 2016		
	Individually	Collectively	Total	Individually	Collectively	Total
Real estate loans:						
Residential Core	$7,719	$ 5,524	$13,243	$8,927	$ 6,141	$15,068
Residential Home Today	2,338	2,189	4,527	2,979	4,437	7,416
Home equity loans and lines of credit	1,411	35,743	37,154	722	38,582	39,304
Construction	—	6	6	—	7	7
Total	$11,468	$ 43,462	$54,930	$12,628	$ 49,167	$61,795

At June 30, 2017 and September 30, 2016, individually evaluated loans that required an allowance were comprised only of loans evaluated for impairment based on the present value of cash flows, such as performing TDRs, and loans with a further deterioration in the fair value of collateral not yet identified as uncollectible. All other individually evaluated loans received a charge-off, if applicable.

14

Table of Contents

Because many variables are considered in determining the appropriate level of general valuation allowances, directional changes in individual considerations do not always align with the directional change in the balance of a particular component of the general valuation allowance. At June 30, 2017 and September 30, 2016, respectively, allowances on individually reviewed loans evaluated for impairment based on the present value of cash flows, such as performing TDRs, were $11,438 and $12,432; and allowances on loans with further deteriorations in the fair value of collateral not yet identified as uncollectible were $30 and $196.
Residential Core mortgage loans represent the largest portion of the residential real estate portfolio. The Company believes overall credit risk is low based on the nature, composition, collateral, products, lien position and performance of the portfolio. The portfolio does not include loan types or structures that have historically experienced severe performance problems at other financial institutions (sub-prime, no documentation or pay option adjustable rate mortgages).
As described earlier in this footnote, Home Today loans have greater credit risk than traditional residential real estate mortgage loans. At June 30, 2017 and September 30, 2016, respectively, approximately 23% and 27% of Home Today loans include private mortgage insurance coverage. The majority of the coverage on these loans was provided by PMI Mortgage Insurance Co., which was seized by the Arizona Department of Insurance in 2011 and currently pays all claim payments at 71.5%. Appropriate adjustments have been made to the Association’s affected valuation allowances and charge-offs, and estimated loss severity factors were adjusted accordingly for loans evaluated collectively. The amount of loans in the Association's total owned residential portfolio covered by mortgage insurance provided by PMIC as of June 30, 2017 and September 30, 2016, respectively, was $68,299 and $91,784, of which $62,956 and $84,007 was current. The amount of loans in the Association's total owned residential portfolio covered by mortgage insurance provided by Mortgage Guaranty Insurance Corporation as of June 30, 2017 and September 30, 2016, respectively, was $31,722 and $40,578 of which $31,500 and $40,190 was current. As of June 30, 2017, MGIC's long-term debt rating, as published by the major credit rating agencies, did not meet the requirements to qualify as "high credit quality"; however, MGIC continues to make claims payments in accordance with its contractual obligations and the Association has not increased its estimated loss severity factors related to MGIC's claim paying ability. No other loans were covered by mortgage insurers that were deferring claim payments or which were assessed as being non-investment grade.
Home equity loans and lines of credit represent a significant portion of the residential real estate portfolio, primarily comprised of home equity lines of credit. Post-origination deterioration in economic and housing market conditions may impact a borrower's ability to afford the higher payments required during the end of draw repayment period that follows the period of interest only payments on home equity lines of credit originated prior to 2012 or the ability to secure alternative financing. Beginning in February 2013, the terms on new home equity lines of credit included monthly principal and interest payments throughout the entire term to minimize the potential payment differential between the during draw and after draw periods.
The Association originates construction loans to individuals for the construction of their personal single-family residence by a qualified builder (construction/permanent loans). The Association’s construction/permanent loans generally provide for disbursements to the builder or sub-contractors during the construction phase as work progresses. During the construction phase, the borrower only pays interest on the drawn balance. Upon completion of construction, the loan converts to a permanent amortizing loan without the expense of a second closing. The Association offers construction/permanent loans with fixed or adjustable rates, and a current maximum loan-to-completed-appraised value ratio of 85%.
Other consumer loans are comprised of loans secured by certificate of deposit accounts, which are fully recoverable in the event of non-payment.
For all classes of loans, a loan is considered impaired when, based on current information and events, it is probable that the Association will be unable to collect the scheduled payments of principal and interest according to the contractual terms of the loan agreement. Factors considered in determining that a loan is impaired may include the deteriorating financial condition of the borrower indicated by missed or delinquent payments, a pending legal action, such as bankruptcy or foreclosure, or the absence of adequate security for the loan.

15

Table of Contents

The recorded investment and the unpaid principal balance of impaired loans, including those reported as TDRs, as of June 30, 2017 and September 30, 2016 are summarized as follows. Balances of recorded investments are adjusted for deferred loan fees or expenses.

	June 30, 2017			September 30, 2016		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related IVA recorded:						
Residential Core	$48,347	$66,531	$ —	$53,560	$72,693	$ —
Residential Home Today	19,511	41,977	—	20,108	44,914	—
Home equity loans and lines of credit	18,958	27,024	—	20,549	30,216	—
Construction	—	—	—	—	—	—
Total	$86,816	$135,532	$ —	$94,217	$147,823	$ —
With an IVA recorded:						
Residential Core	$50,021	$50,615	$ 7,719	$53,981	$54,717	$ 8,927
Residential Home Today	28,588	28,930	2,338	31,307	31,725	2,979
Home equity loans and lines of credit	19,927	19,944	1,411	15,345	15,357	722
Construction	—	—	—	—	—	—
Total	$98,536	$99,489	$ 11,468	$100,633	$101,799	$ 12,628
Total impaired loans:						
Residential Core	$98,368	$117,146	$ 7,719	$107,541	$127,410	$ 8,927
Residential Home Today	48,099	70,907	2,338	51,415	76,639	2,979
Home equity loans and lines of credit	38,885	46,968	1,411	35,894	45,573	722
Construction	—	—	—	—	—	—
Total	$185,352	$235,021	$ 11,468	$194,850	$249,622	$ 12,628

At June 30, 2017 and September 30, 2016, respectively, the recorded investment in impaired loans includes $165,511 and $170,602 of loans restructured in TDRs of which $12,621 and $12,368 were 90 days or more past due.

Table of Contents

The average recorded investment in impaired loans and the amount of interest income recognized during the period that the loans were impaired are summarized below.

	For the Three Months Ended June 30,			
	2017		2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related IVA recorded:				
Residential Core	$49,609	$ 383	$56,115	$ 303
Residential Home Today	19,484	133	20,712	71
Home equity loans and lines of credit	19,162	75	20,584	70
Construction	—	—	—	—
Total	$88,255	$ 591	$97,411	$ 444
With an IVA recorded:				
Residential Core	$49,932	$ 473	$55,453	$ 544
Residential Home Today	28,923	361	32,933	412
Home equity loans and lines of credit	19,645	124	13,490	93
Construction	—	—	—	—
Total	$98,500	$ 958	$101,876	$ 1,049
Total impaired loans:				
Residential Core	$99,541	$ 856	$111,568	$ 847
Residential Home Today	48,407	494	53,645	483
Home equity loans and lines of credit	38,807	199	34,074	163
Construction	—	—	—	—
Total	$186,755	$ 1,549	$199,287	$ 1,493

	For the Nine Months Ended June 30,			
	2017		2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related IVA recorded:				
Residential Core	$50,954	$ 1,125	$58,808	$ 949
Residential Home Today	19,810	282	21,626	286
Home equity loans and lines of credit	19,754	224	21,634	207
Construction	—	—	—	—
Total	$90,518	$ 1,631	$102,068	$ 1,442
With an IVA recorded:				
Residential Core	$52,001	$ 1,451	$55,980	$ 1,702
Residential Home Today	29,948	1,099	33,837	1,267
Home equity loans and lines of credit	17,636	722	12,763	253
Construction	—	—	213	—
Total	$99,585	$ 3,272	$102,793	$ 3,222
Total impaired loans:				
Residential Core	$102,955	$ 2,576	$114,788	$ 2,651
Residential Home Today	49,758	1,381	55,463	1,553
Home equity loans and lines of credit	37,390	946	34,397	460

Construction	—	—	213	—
Total	$190,103	$ 4,903	$204,861	$ 4,664

17

Table of Contents

Interest on loans in non-accrual status is recognized on a cash basis. The amount of interest income on impaired loans recognized using a cash basis method was $415 and $1,185 for the three and nine months ended June 30, 2017, respectively, and $326 and $1,090 for the three and nine months ended June 30, 2016. Cash payments on loans with a partial charge-off are applied fully to principal, then to recovery of the charged off amount prior to interest income being recognized. Interest income on the remaining impaired loans is recognized on an accrual basis.
Charge-offs on residential mortgage loans, home equity loans and lines of credit, and construction loans are recognized when triggering events, such as foreclosure actions, short sales, or deeds accepted in lieu of repayment, result in less than full repayment of the recorded investment in the loans.
Partial or full charge-offs are also recognized for the amount of impairment on loans considered collateral dependent that meet the conditions described below.

- For residential mortgage loans, payments are 180 days delinquent;
- For home equity lines of credit, equity loans, and residential loans restructured in a TDR, payments are greater than 90 days delinquent;
- For all classes of loans, a sheriff sale is scheduled within 60 days to sell the collateral securing the loan;
- For all classes of loans, all borrowers have been discharged of their obligation through a Chapter 7 bankruptcy;
- For all classes of loans, within 60 days of notification, all borrowers obligated on the loan have filed Chapter 7 bankruptcy and have not reaffirmed or been dismissed;
- For all classes of loans, a borrower obligated on a loan has filed bankruptcy and the loan is greater than 30 days delinquent; and
- For all classes of loans, it becomes evident that a loss is probable.

Collateral dependent residential mortgage loans and construction loans are charged off to the extent the recorded investment in a loan, net of anticipated mortgage insurance claims, exceeds the fair value less costs to dispose of the underlying property. Management can determine the loan is uncollectible for reasons such as foreclosures exceeding a reasonable time frame and recommend a full charge-off. Home equity loans or lines of credit are charged off to the extent the recorded investment in the loan plus the balance of any senior liens exceeds the fair value less costs to dispose of the underlying property or management determines the collateral is not sufficient to satisfy the loan. A loan in any portfolio that is identified as collateral dependent will continue to be reported as impaired until it is no longer considered collateral dependent, is less than 30 days past due and does not have a prior charge-off. A loan in any portfolio that has a partial charge-off consequent to impairment evaluation will continue to be individually evaluated for impairment until, at a minimum, the impairment has been recovered.
The following summarizes the effective dates of charge-off policies that changed or were first implemented during the current and previous four fiscal years and the portfolios to which those policies apply.

Effective Date	Policy	Portfolio(s) Affected
6/30/2014	A loan is considered collateral dependent and any collateral shortfall is charged off when, within 60 days of notification, all borrowers obligated on a loan filed Chapter 7 bankruptcy and have not reaffirmed or been dismissed (1)	All

(1) Prior to 6/30/2014, collateral shortfalls on loans in Chapter 7 bankruptcy were charged off when all borrowers were discharged of the obligation or when the loan was 30 days or more past due.
Loans restructured in TDRs that are not evaluated based on collateral are separately evaluated for impairment on a loan by loan basis at the time of restructuring and at each subsequent reporting date for as long as they are reported as TDRs. The impairment evaluation is based on the present value of expected future cash flows discounted at the effective interest rate of the original loan. Expected future cash flows include a discount factor representing a potential for default. Valuation allowances are recorded for the excess of the recorded investments over the result of the cash flow analysis. Loans discharged in Chapter 7 bankruptcy are reported as TDRs and also evaluated based on the present value of expected future cash flows unless evaluated based on collateral. We evaluate these loans using the

expected future cash flows because we expect the borrower, not liquidation of the collateral, to be the source of repayment for the loan. Other consumer loans are not considered for restructuring. A loan restructured in a TDR is classified as an impaired loan for a minimum of one year. After one year, that loan may be reclassified out of the balance of impaired loans if the loan was restructured to yield a market rate for loans of similar credit risk at the time of restructuring and the loan is not impaired based on the terms of the restructuring agreement. No

Table of Contents

loans whose terms were restructured in TDRs were reclassified from impaired loans during the nine months ended June 30, 2017 and June 30, 2016.

The recorded investment in TDRs by type of concession as of June 30, 2017 and September 30, 2016 is shown in the tables below.

June 30, 2017	Reduction in Interest Rates	Payment Extensions	Forbearance or Other Actions	Multiple Concessions	Multiple Restructurings	Bankruptcy	Total
Residential Core	$ 12,783	$ 539	$ 8,538	$ 21,277	$ 21,354	$ 24,777	$89,268
Residential Home Today	5,504	—	4,934	10,703	19,672	4,674	45,487
Home equity loans and lines of credit	110	5,071	382	14,145	1,647	9,401	30,756
Total	$ 18,397	$ 5,610	$ 13,854	$ 46,125	$ 42,673	$ 38,852	$165,511

September 30, 2016	Reduction in Interest Rates	Payment Extensions	Forbearance or Other Actions	Multiple Concessions	Multiple Restructurings	Bankruptcy	Total
Residential Core	$ 13,456	$ 748	$ 8,595	$ 22,641	$ 21,517	$ 28,263	$95,220
Residential Home Today	6,338	—	5,198	11,330	20,497	5,241	48,604
Home equity loans and lines of credit	120	4,135	401	9,354	1,166	11,602	26,778
Total	$ 19,914	$ 4,883	$ 14,194	$ 43,325	$ 43,180	$ 45,106	$170,602

TDRs may be restructured more than once. Among other requirements, a subsequent restructuring may be available for a borrower upon the expiration of temporary restructuring terms if the borrower cannot return to regular loan payments. If the borrower is experiencing an income curtailment that temporarily has reduced his/her capacity to repay, such as loss of employment, reduction of hours, non-paid leave or short term disability, a temporary restructuring is considered. If the borrower lacks the capacity to repay the loan at the current terms due to a permanent condition, a permanent restructuring is considered. In evaluating the need for a subsequent restructuring, the borrower's ability to repay is generally assessed utilizing a debt to income and cash flow analysis. As the economy has improved, the need for multiple restructurings has begun to abate. Loans discharged in Chapter 7 bankruptcy are classified as multiple restructurings if the loan's original terms had also been restructured by the Association.

For all loans restructured during the three and nine months ended June 30, 2017 and June 30, 2016 (set forth in the tables below), the pre-restructured outstanding recorded investment was not materially different from the post-restructured outstanding recorded investment.

The following tables set forth the recorded investment in TDRs restructured during the periods presented, according to the types of concessions granted.

	For the Three Months Ended June 30, 2017						
	Reduction in Interest Rates	Payment Extensions	Forbearance or Other Actions	Multiple Concessions	Multiple Restructurings	Bankruptcy	Total
Residential Core	$52	$ —	$ 567	$ 414	$ 731	$ 702	$2,466
Residential Home Today	—	—	281	115	870	168	1,434
Home equity loans and lines of credit	—	284	32	1,983	467	65	2,831
Total	$52	$ 284	$ 880	$ 2,512	$ 2,068	$ 935	$6,731

Table of Contents

	For the Three Months Ended June 30, 2016						
	Reduction in Interest Rates	Payment Extensions	Forbearance or Other Actions	Multiple Concessions	Multiple Restructurings	Bankruptcy	Total
Residential Core	$204	$ —					