

TFS Financial CORP
Form 10-K
November 24, 2010

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 September 30, 2010

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)

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United States of America
(State or Other Jurisdiction of

52-2054948
(I.R.S. Employer

Incorporation or Organization)
7007 Broadway Avenue
Cleveland, Ohio
(Address of Principal Executive Offices)

Identification No.)
44105
(Zip Code)

(216) 441-6000

(Registrant's telephone number, including area code)

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

Common Stock, par value \$0.01 per share

(Title of class)

The NASDAQ Stock Market, LLC

(Name of exchange on which registered)

Securities registered pursuant to Section 12(g) of the 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 Section 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 such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No .

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. .

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(do not check if a smaller reporting company)

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

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The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the last sale price on March 31, 2010, as reported by the NASDAQ Global Select Market, was approximately \$1.07 billion.

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

At November 17, 2010 there were 308,395,000 shares of the Registrant's common stock, par value \$0.01 per share, outstanding, of which 227,119,132 shares, or 73.65% of the Registrant's common stock, were held by Third Federal Savings and Loan Association of Cleveland, MHC, the Registrant's mutual holding company.

DOCUMENTS INCORPORATED BY REFERENCE (to the Extent Indicated Herein)

Portions of the registrant's Proxy Statement for the 2011 Annual Meeting of Shareholders are incorporated by reference in Part III hereof.

TFS Financial Corporation

INDEX

Part I

Item 1.	<u>Business</u>	3
Item 1A.	<u>Risk Factors</u>	46
Item 1B.	<u>Unresolved Staff Comments</u>	52
Item 2.	<u>Properties</u>	52
Item 3.	<u>Legal Proceedings</u>	52
Item 4.	<u>[Removed and Reserved]</u>	52

Part II

Item 5.	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	53
Item 6.	<u>Selected Financial Data</u>	55
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operation</u>	57
Item 7A.	<u>Quantitative and Qualitative Disclosures About Market Risk.</u>	77
Item 8.	<u>Financial Statements and Supplementary Data</u>	80
Item 9.	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	80
Item 9A.	<u>Controls and Procedures</u>	80
Item 9B.	<u>Other Information</u>	83

Part III

Item 10.	<u>Directors, Executive Officers and Corporate Governance</u>	83
Item 11.	<u>Executive Compensation</u>	84
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	84
Item 13.	<u>Certain Relationships and Related Transactions, and Director Independence</u>	84
Item 14.	<u>Principal Accounting Fees and Services</u>	84

Part IV

Item 15.	<u>Exhibits and Financial Statement Schedules</u>	84
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PART I

Item 1. Business
Forward Looking Statements

This report contains forward-looking statements, which can be identified by the use of such words as estimate, project, believe, intend, anticipate, plan, seek, expect and similar expressions. These forward-looking statements include:

statements of our goals, intentions and expectations;

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

statements concerning trends in our provision for loan losses and charge-offs;

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 subject to significant risks, assumptions and uncertainties, including, among other things, the following important factors that could affect the actual outcome of future events:

significantly increased competition among depository and other financial institutions;

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

general economic conditions, either nationally or in our market areas, including employment prospects and conditions that are worse than expected;

decreased demand for our products and services and lower revenue and earnings because of a recession;

adverse changes and volatility in the securities markets;

adverse changes and volatility in credit markets;

legislative or regulatory changes that adversely affect our business, including changes in regulatory costs and capital requirements;

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our ability to enter new markets successfully and take advantage of growth opportunities, and the possible short-term dilutive effect of potential acquisitions or de novo branches, if any;

changes in consumer spending, borrowing and savings habits;

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

future adverse developments concerning Fannie Mae or Freddie Mac;

changes in monetary and fiscal policy of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board;

changes in policy and/or assessment rates of taxing authorities that adversely affect us;

the timing and the amount of revenue that we may recognize;

changes in expense trends (including, but not limited to trends affecting non-performing assets, charge-offs and provisions for loan losses);

changes in consumer spending, borrowing and spending habits;

inability of third-party providers to perform their obligations to us;

a slowing or failure of the moderate economic recovery that began last year;

the extensive reforms enacted in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which will impact us;

the adoption of implementing regulations by a number of different regulatory bodies under the Dodd-Frank Act, and uncertainty in the exact nature, extent and timing of such regulations and the impact they will have on us;

changes in our organization, or compensation and benefit plans; and

the strength or weakness of the real estate markets and of the consumer and commercial credit sectors and those markets and sectors impact on the credit quality of our loans and other assets.

Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements. Please see Item 1A. Risk Factors, for a discussion of certain risks related to our business.

TFS FINANCIAL CORPORATION

TFS Financial Corporation (we us our or the Company) was organized in 1997 as the mid-tier stock holding company for Third Federal Savings and Loan Association of Cleveland (Third Federal Savings and Loan or the Association). We completed our initial public stock offering on April 20, 2007 and issued 100,199,618 shares of common stock, or 30.16% of our post-offering outstanding common stock, to subscribers in the offering. Additionally, at the time of the public offering, 5,000,000 shares of our common stock, or 1.50% of our outstanding shares, were issued to our newly formed charitable foundation, Third Federal Foundation (the Foundation). Third Federal Savings and Loan Association of Cleveland, MHC (Third Federal Savings, MHC), our mutual holding company parent, holds the remainder of our outstanding common stock (227,119,132 shares). Net proceeds from our initial public stock offering were approximately \$886 million and reflected the costs we incurred in completing the offering as well as a \$106.5 million loan to the Third Federal Employee Stock Ownership Plan related to its acquisition of shares in the initial public stock offering.

Our ownership of the Association remains our primary business activity.

We also operate Third Capital, Inc. as a wholly-owned subsidiary.

As the holding company of Third Federal Savings and Loan, we are authorized to pursue other business activities permitted by applicable laws and regulations for savings and loan holding companies, which include making equity investments and the acquisition of banking and financial services companies.

Our cash flow depends primarily on earnings from the investment of the portion of the net offering proceeds we retained, and any dividends we receive from Third Federal Savings and Loan and Third Capital, Inc. The majority of our officers are also officers of the Association. In addition, we use the services of the support staff of the Association from time to time. We may hire additional employees, as needed, to the extent we expand our business in the future.

THIRD CAPITAL, INC.

Third Capital, Inc. is a Delaware corporation that was organized in 1998 as our wholly-owned subsidiary. At September 30, 2010, Third Capital, Inc. had consolidated assets of \$79.6 million, and for the fiscal year ended September 30, 2010, Third Capital, Inc. had consolidated net income of \$2.1 million. Third Capital, Inc. has no separate operations other than as the holding company for its operating subsidiaries, and as a minority investor or partner in other entities including minority investments in private equity funds. The following is a description of the entities, other than the private equity funds, in which Third Capital, Inc. is the owner, an investor or a partner.

Hazelmere Investment Group I, Ltd. This entity engages in net lease transactions of commercial buildings in targeted markets. Third Capital, Inc. is a partner of this entity, receives a preferred return on amounts contributed to acquire investment properties and has a 70% ownership interest in remaining earnings. A former director of the Company indirectly owns or controls the majority of the remaining 30% ownership interest of this entity. A similar structured entity, Hazelmere of California Limited Partnership, which sold its commercial building in 2007 and has had minimal subsequent activity, was dissolved during fiscal 2009. Overall, the Hazelmere entity had pre-tax income of \$1.5 million during fiscal 2010.

Third Cap Associates, Inc. This Ohio corporation also maintains minority investments in private equity funds, and owns 49% and 60%, respectively, of two title agencies that provide escrow and settlement services in the State of Ohio, primarily to customers of Third Federal Savings and Loan. For the fiscal year ended September 30, 2010, Third Cap Associates, Inc. recorded net income of \$1.2 million.

Third Capital Mortgage Insurance Company. This Vermont corporation reinsures private mortgage insurance on residential mortgage loans originated by Third Federal Savings and Loan. For the fiscal year ended September 30, 2010, Third Capital Mortgage Insurance Company recorded net income of \$264 thousand.

THIRD FEDERAL SAVINGS AND LOAN ASSOCIATION OF CLEVELAND

General

Third Federal Savings and Loan is a federally chartered savings and loan association headquartered in Cleveland, Ohio that was organized in 1938. In May 1997, the Association reorganized into its current two-tier mutual holding company structure. The Association's principal business consists of originating and servicing residential real estate mortgage loans and home equity loans and lines of credit and attracting retail savings deposits.

The Association's business strategy is to originate mortgage loans with interest rates that are competitive with those of similar products offered by other financial institutions in its markets. Similarly, the Association offers high-yield checking accounts and high-yield savings accounts and certificate of deposit accounts, each bearing interest rates that are competitive with similar products offered by other financial institutions in its markets. The Association expects to continue to pursue this business philosophy. While this strategy does not enable it to earn the highest rates of interest on loans it offers or pay the lowest rates on its deposit accounts, the Association believes that this strategy is the primary reason for its successful growth in the past.

The Association attracts retail deposits from the general public in the areas surrounding its main office and its branch offices. It also utilizes its internet website and its telephone call center to generate loan applications and attract retail deposits. In addition to residential real estate mortgage loans, the Association originates residential construction loans. Prior to July 2010, the Association also actively originated home equity loans and lines of credit. The Association retains in its portfolio a large portion of the loans that it originates. Loans that the Association sells consist primarily of long-term, fixed-rate residential real estate mortgage loans. The Association retains the servicing rights on all loans that it sells. The Association's revenues are derived primarily from interest on loans and, to a lesser extent, interest on interest-bearing deposits in other financial institutions, deposits maintained at the Federal Reserve, federal funds sold, and investment securities including mortgage-backed securities. The Association also generates revenues from fees and service charges. The Association's primary sources of funds are deposits, borrowings, principal and interest payments on loans and securities and proceeds from loan sales.

The Association's website address is www.thirdfederal.com. Filings of the Company made with the Securities and Exchange Commission are available for free on the Association's website. Information on that website is not and should not be considered a part of this document.

Market Area

Third Federal Savings and Loan conducts its operations from its main office in Cleveland, Ohio, and from 39 additional, full-service branches and eight loan production offices located throughout the states of Ohio and Florida. In Ohio, the Association's 22 full-service offices are located in the northeast Ohio counties of Cuyahoga, Lake, Lorain, Medina and Summit, four loan production offices are located in the central Ohio county of Franklin (Columbus, Ohio) and four loan production offices are located in the southern Ohio counties of Butler and Hamilton (Cincinnati, Ohio). In Florida, 17 full-service branches are located in the counties of Pasco, Pinellas, Hillsborough, Sarasota, Lee, Collier, Palm Beach and Broward. The economies and housing markets in Ohio and Florida have been negatively impacted by the current economic downturn. Both states have experienced dramatic increases in foreclosures and reductions in employment rates and housing values. The depressed housing market and employment uncertainties have created consumer pessimism and apprehension, which is manifested in suppressed consumer housing demand. Additionally, during the last two years, as the Federal Deposit Insurance Corporation (FDIC) has administered the resolution of hundreds of troubled financial institutions, the Depository Insurance Fund (DIF) has incurred significant losses and the reserves of the DIF have been substantially depleted. This depletion has prompted a re-examination of the method of assessing insured institutions and re-building the fund. Further, Section 331(b) of the Dodd-Frank Act, which was signed into law in July 2010, requires that the FDIC amend its regulations to define assessment base as an insured institution's average total assets minus average tangible equity during the assessment period. This revision has the effect of eliminating the funding cost advantage that borrowings generally had when compared to the funding cost associated with deposits. As a result, many financial institutions, including institutions that compete in our markets, have targeted retail deposit gathering as a more attractive funding source, and have become more active and more competitive in their deposit product pricing. The combination of reduced demand by borrowers and more competition with respect to rates paid to depositors has created an increasingly difficult marketplace that could adversely affect future operating results.

The Association also provides savings products in all 50 states through its internet site.

Competition

The Association faces intense competition in its market areas both in making loans and attracting deposits. Its market areas have a high concentration of financial institutions, including large money center and regional banks, community banks and credit unions, and it faces additional competition for deposits from money market funds, brokerage firms, mutual funds and insurance companies. Some of its competitors offer products and services that the Association currently does not offer, such as commercial business loans, trust services and private banking.

The majority of the Association's deposits are held in its offices located in Cuyahoga County, Ohio. As of June 30, 2010 (the latest date for which information is publicly available), the Association had \$4.99 billion of deposits in Cuyahoga County, and ranked second among all financial institutions with offices in the county in terms of deposits, with a market share of 13.24%. As of that date, the Association had \$6.28 billion of deposits in the State of Ohio, and ranked 9th among all financial institutions in the state in terms of deposits, with a market share of 2.78%. As of June 30, 2010, the Association had \$2.78 billion of deposits in the State of Florida, and ranked 24th among all financial institutions in terms of deposits, with a market share of 0.68%.

From October 2009 through September 2010, the Association had the largest market share of conventional purchase mortgage loans originated in Cuyahoga County, Ohio. For the same period, it also had the largest market share of conventional purchase mortgage loans originated in the seven northeast Ohio counties which comprise the Cleveland and Akron metropolitan statistical areas. In addition, based on the same statistics, the Association has consistently been one of the six largest lenders in Franklin County (Columbus, Ohio) and Hamilton County (Cincinnati, Ohio) since it entered those markets in 1999.

The Association's primary strategy for increasing and retaining its customer base is to offer competitive deposit and loan rates and other product features, delivered with exceptional customer service, in each of the markets it serves.

We rely on the Association's more than 70-year history of serving its customers and the communities in which it operates, the Association's high capital levels, and liquidity alternatives to maintain and nurture customer and marketplace confidence. The Company's high capital ratio continues to reflect the beneficial impact of our April 2007 initial public offering, which raised net proceeds of \$886 million. At September 30, 2010, our ratio of shareholders' equity to total assets was 15.8%. Our liquidity alternatives include management and monitoring of the level of liquid assets held in our portfolio as well as the maintenance of alternative wholesale funding sources. At September 30, 2010, our liquidity ratio was 12.51% (which we compute as the sum of cash and cash equivalents plus unpledged investment securities for which ready markets exist, divided by total assets) and, through the Association, we had the ability to immediately borrow an additional \$910.0 million from the Federal Home Loan Bank of Cincinnati (FHLB of Cincinnati) under existing credit arrangements along with \$360.3 million from the Federal Reserve Bank of Cleveland (Federal Reserve). See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation Liquidity and Capital Resources.

We continue to utilize a multifaceted approach to support our efforts to instill customer and marketplace confidence. First, we provide thorough and timely information to all of our associates so as to prepare them for their day-to-day interactions with customers and other individuals who are not part of the Company. We believe that it is important that our customers and others sense the comfort level and confidence of our associates throughout their dealings. Second, we encourage our management team to maintain a presence and to be available in our branches and other areas of customer contact, so as to provide more opportunities for informal contact and interaction with our customers and community members. Third, our CEO remains accessible to both local and national media, as a spokesman for our institution as well as an observer and interpreter of financial marketplace situations and events. Fourth, we periodically include advertisements in local newspapers that display our strong capital levels and history of service. We also continue to emphasize our traditional tagline "STRONG * STABLE * SAFE" in our advertisements and branch displays. Finally, for customers who adhere to the old adage of trust but verify, we refer them to the safety/security rankings of a nationally recognized, independent rating organization that specializes in the evaluation of financial institutions which has awarded Third Federal Savings and Loan its highest rating.

Lending Activities

The Association's principal lending activity is the origination of first mortgage loans to purchase or refinance residential real estate. Its current policies generally provide that it will maintain between 40% and 70% of its assets in fixed-rate, residential real estate, first mortgage loans and up to 20% of its assets in adjustable-rate, residential real estate, first mortgage loans, subject to its liquidity levels and the credit demand of its customers. The Association also originates residential construction loans and prior to June 28, 2010 originated a significant amount of home equity loans and lines of credit. Refer to *Monitoring and Limiting Our Credit Risk* section in Item 7 for additional information regarding home equity loans and lines of credit. At September 30, 2010, residential real estate mortgage loans totaled \$6.42 billion, or 68.5% of our loan portfolio, home equity loans and lines of credit totaled \$2.85 billion, or 30.4% of our loan portfolio, and residential construction loans totaled \$100.4 million, or 1.1% of our loan portfolio.

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Loan Portfolio Composition. The following table sets forth the composition of the loan portfolio, by type of loan segregated by geographic location at the dates indicated, excluding loans held for sale. Construction loans are on properties located in Ohio and the balances of Consumer loans are immaterial. Therefore, neither was segregated by geographic location.

	2010		2009		At September 30, 2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Real estate loans:										
Residential non-Home Today(1)										
Ohio	\$ 4,843,804		\$ 4,582,542		\$ 5,133,689		\$ 4,732,374		\$ 4,225,297	
Florida	1,168,701		1,285,426		1,105,836		970,936		931,688	
Kentucky	125,949		122,315		159,967		139,517		121,305	
Total Residential non-Home Today	6,138,454	65.4%	5,990,283	64.0%	6,399,492	68.7%	5,842,827	71.5%	5,278,290	69.4%
Residential Home Today(1)										
Ohio	268,983		279,835		291,386		292,642		276,478	
Florida	10,940		11,128		11,070		10,695		8,327	
Kentucky	610		729		697		709		687	
Total Residential Home Today	280,533	3.0	291,692	3.1	303,153	3.3	304,046	3.7	285,492	3.8
Home equity loans and lines of credit(2)										
Ohio	1,145,819		1,192,498		1,098,912		1,008,716		954,448	
Florida	797,658		831,979		731,538		481,605		327,471	
California	324,778		343,432		292,100		109,440		150,134	
Other	580,435		615,094		365,504		268,138		371,847	
Total Home equity loans and lines of credit	2,848,690	30.4	2,983,003	31.8	2,488,054	26.7	1,867,899	22.8	1,803,900	23.7
Construction	100,404	1.1	94,287	1.0	115,323	1.2	150,695	1.8	207,634	2.7
Commercial	0	0.0	0	0.0	0	0.0	0	0.0	2,335	0.0
Consumer loans:										
Automobile	1	0.0	35	0.0	1,044	0.0	5,627	0.1	15,676	0.2
Other loans	7,198	0.1	7,072	0.1	6,555	0.1	9,065	0.1	12,793	0.2
Total loans receivable	9,375,280	100.0%	9,366,372	100.0%	9,313,621	100.0%	8,180,159	100.0%	7,606,120	100.0%
Deferred loan costs (fees)	(15,283)		(10,463)		(14,596)		(19,174)		(18,698)	
Loans in process	(45,008)		(41,076)		(46,493)		(62,167)		(89,676)	
Allowance for loan losses	(133,240)		(95,248)		(43,796)		(25,111)		(20,705)	
Total loans receivable, net	\$ 9,181,749		\$ 9,219,585		\$ 9,208,736		\$ 8,073,707		\$ 7,477,041	

(1) See the *Residential Real Estate Mortgage Loans* section which follows for a description of Home Today and non-Home Today loans.

(2) Includes bridge loans.

Loan Portfolio Maturities. The following table summarizes the scheduled repayments of the loan portfolio at September 30, 2010. Demand loans, loans having no stated repayment schedule or maturity, and overdraft loans are reported as being due in the fiscal year ending September 30, 2011. Maturities are based on the final contractual payment date and do not reflect the impact of prepayments and scheduled principal amortization.

Due During the Years Ending September 30,	Residential Real Estate		Home Equity Loans and Lines of Credit(1)	Construction Loans (In thousands)	Automobile Loans	Other Consumer Loans	Total
	Non-Home Today	Home Today					
2011	\$ 9,859	\$ 0	\$ 10,363	\$ 23,341	\$ 1	\$ 5,607	\$ 49,171
2012	2,513	0	4,722	5,837	0	0	13,072
2013	16,481	0	4,767	1,468	0	0	22,716
2014 to 2015	29,180	39	13,924	0	0	343	43,486
2016 to 2020	331,688	3,089	66,322	0	0	1,248	402,347
2021 to 2025	694,112	4,303	438,552	6,638	0	0	1,143,605
2026 and beyond	5,054,621	273,102	2,310,040	63,120	0	0	7,700,883
Total	\$ 6,138,454	\$ 280,533	\$ 2,848,690	\$ 100,404	\$ 1	\$ 7,198	\$ 9,375,280

(1) Includes bridge loans.

The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at September 30, 2010 that are contractually due after September 30, 2011.

	Due After September 30, 2010		Total
	Fixed	Adjustable (In thousands)	
Real estate loans:			
Residential non-Home Today	\$ 5,236,603	\$ 891,992	\$ 6,128,595
Residential Home Today	280,237	296	280,533
Home Equity Loans and Lines of Credit(1)	110,408	2,727,919	2,838,327
Construction	62,340	14,723	77,063
Consumer Loans:			
Other	1,591	0	1,591
Total	\$ 5,691,179	\$ 3,634,930	\$ 9,326,109

(1) Includes bridge loans.

Residential Real Estate Mortgage Loans. The Association's primary lending activity is the origination of residential real estate mortgage loans. At September 30, 2010, \$6.42 billion, or 68.5% of its total loan portfolio, consisted of residential real estate mortgage loans. A comparison of 2010 data to the corresponding 2009 data and the Company's expectations for 2011 can be found in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation. The Association offers fixed-rate residential real estate mortgage loans with a maximum loan amount of \$417,000 and adjustable-rate residential real estate mortgage loans with a maximum loan amount of \$625,000.

The Association currently offers fixed-rate conventional mortgage loans with terms of up to 30 years that are fully amortizing with monthly loan payments, and adjustable-rate mortgage loans that amortize over a period of up to 30 years, provide an initial fixed interest rate for three or five years and then adjust annually. The Association originates fixed-rate mortgage loans with terms of less than 15 years, but at rates applicable to our 15-year loans. Effective March 11, 2009, the Association stopped offering interest only residential real estate mortgage loans, where the borrower pays interest for an initial period (one, three or five years), after which the loan converts to a fully amortizing loan. At September 30,

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2010, interest only residential real estate mortgage loans totaled \$133.5 million. The Association's Lowest Rate Guarantee program provides that, subject to the terms and conditions of the guarantee program, if a loan applicant finds a lower interest rate on a residential real

estate mortgage loan than the rate the Association offers, the Association will offer a lower rate or, after the applicant closes a loan with another lender at the lower interest rate, pay the loan applicant \$1,000.

Historically, residential real estate mortgage loans were generally underwritten according to Fannie Mae's dollar limit requirements, and the Association referred to these loans that conform to such limits as conforming loans. Effective July 1, 2010, Fannie Mae, the Association's primary loan investor, implemented certain loan origination requirement changes affecting loan eligibility that we did not adopt, as explained below. The Association generally originates both fixed- and adjustable-rate mortgage loans in amounts up to the maximum conforming loan limits as established by the Office of Federal Housing Enterprise Oversight, which are currently \$417,000 and \$625,000, respectively, for single-family homes in most of our lending markets. The Association also originates loans above the lending limit for conforming loans, which the Association refers to as jumbo loans. The Association generally underwrites jumbo loans in a manner similar to conforming loans. Jumbo loans are not uncommon in the Association's market areas. During periods of high market activity, these jumbo loans are generally eligible for sale to various firms that specialize in purchasing non-conforming loans although, since the beginning of the mortgage crisis in 2008, there has been virtually no activity with respect to the sale of non-conforming loans. The Association has not sold any jumbo loans since June 2005.

The Association has always considered the promotion of home ownership a primary goal. In that regard, it has historically offered affordable housing programs in all of its market areas. These programs are targeted toward low- and moderate-income home buyers. The Association's primary program is called Home Today and is described in detail below. Prior to March 27, 2009, loans originated under the Home Today program had higher risk characteristics. The Association did not classify it as a sub-prime lending program based on the exclusion provided to community development loans in the Office of Thrift Supervision's *Expanded Guidance for Sub-prime Lending*. During the last several years, attention has focused on sub-prime lending and its negative effect on borrowers and financial markets. Borrowers in the Home Today program are not charged higher fees or interest rates than non-Home Today borrowers. These loans are not interest only or negative amortizing and contain no low initial payment features or adjustable interest rates, which are features often associated with sub-prime lending. While the credit risk profiles of the Association's borrowers in the Home Today program are generally higher risk than the credit risk profiles of its non-Home Today borrowers, the Association attempts to mitigate that higher risk through the use of private mortgage insurance and continued pre- and post-purchase counseling. The Association's philosophy has been to provide borrowers the opportunity for home ownership within their financial means. Effective March 27, 2009, the Home Today underwriting guidelines were revised so as to be substantially the same as for the Association's traditional first mortgage product.

Prior to March 27, 2009, through the Home Today program, the Association originated loans with its standard terms to borrowers who might not have otherwise qualified for such loans. After March 27, 2009 borrowers under the Home Today program are subject to the same qualification requirements as non-Home Today borrowers. To qualify for the Association's Home Today program, a borrower must complete financial management education and counseling and must be referred to the Association by a sponsoring organization with which the Association has partnered as part of the program. Borrowers must meet a minimum credit score threshold. The Association will originate loans with a loan-to-value ratio of up to 90% through its Home Today program, provided that any loan originated through this program with a loan-to-value ratio in excess of 80% must meet the underwriting criteria mandated by its private mortgage insurance carrier. Because the Association previously applied less stringent underwriting and credit standards to these loans, the vast majority of loans originated under the Home Today program generally have greater credit risk than our traditional residential real estate mortgage loans. Effective October 2007, the private mortgage insurance carrier that provides coverage for the Home Today loans with loan-to-value ratios in excess of 80% imposed more restrictive lending requirements that have decreased the volume of Home Today lending, which we expect will continue. As of September 30, 2010, the Association had \$280.5 million of loans outstanding that were originated through its Home Today program. Originations under the Home Today program have effectively stopped as a result of these new requirements. See *Non-performing and Problem Assets - Delinquent Loans* for a discussion of the asset quality of this portion of the Association's loan portfolio.

Prior to November 25, 2008 the Association also originated loans under its High LTV program. These loans have loan-to-value ratios of 90% or greater, and may be as high as 95%. To qualify for this program, the loan applicant was required to satisfy more stringent underwriting criteria (credit score, income qualification, and other criteria). Borrowers do not obtain private mortgage insurance with respect to these loans. High LTV loans were originated with higher interest rates than the Association's other residential real estate loans. The higher credit quality of this portion of the Association's portfolio offsets the risk of not requiring private mortgage insurance. While these loans were not initially covered by private mortgage insurance, the Association had negotiated with a private mortgage insurance carrier a contract under which, at the Association's option, a pre-determined dollar amount of qualifying loans may be grouped and submitted to the carrier for pooled private mortgage insurance coverage. As of September 30, 2010, the Association had \$322.3 million of loans outstanding that were originated through its High LTV program, \$280.3 million of which the Association has insured through a mortgage insurance carrier. The High LTV program was suspended November 25, 2008.

For loans with loan-to-value ratios in excess of 80% but equal to or less than 90% (which are available only for purchase transactions), the Association requires private mortgage insurance, except that for adjustable-rate, first mortgage loans that meet enhanced credit qualification parameters, loan-to-value ratios of up to 85% may be obtained without private mortgage insurance. Loan-to-value ratios in excess of 80% are not available for refinance transactions.

The Association actively monitors its interest rate risk position to determine the desirable level of investment in fixed-rate mortgages. Prior to July 2010, depending primarily on market interest rates and its capital and liquidity positions, the Association elected to: (1) retain all of its newly originated longer-term fixed-rate residential mortgage loans, (2) sell all or a portion of such loans in the secondary mortgage market to governmental entities such as Fannie Mae or other purchasers; or (3) securitize such loans by selling the loans in exchange for mortgage-backed securities. Securitized loans can be sold more readily to meet liquidity or interest rate risk management needs, and have a lower risk-weight than the underlying loans, which reduces the Association's regulatory capital requirements. All of the loans that the Association sold or securitized during the five fiscal years ended September 30, 2010 were fixed-rate mortgage loans.

Effective July 1, 2010, Fannie Mae, the Association's primary loan investor, implemented certain loan origination requirement changes affecting loan eligibility that we did not adopt. Accordingly, the Association's ability to reduce interest rate risk via our traditional loan sales of newly originated longer-term fixed rate residential loans is limited until the Association either changes its loan origination processes or Fannie Mae, Freddie Mac or other market participants, revise their loan eligibility standards. Otherwise, future sales of fixed-rate mortgage loans will predominately be limited to those loans that have established payment histories, strong borrower credit profiles and are supported by adequate collateral values. In response to this change, the Association developed, and on July 21, 2010, began marketing a new adjustable-rate mortgage loan product that provides the Association with improved interest rate risk characteristics when compared to a long-term, fixed-rate mortgage.

Historically, during periods of low market interest rates, the Association has sold a portion, sometimes substantial, of its newly originated fixed-rate residential real estate mortgage loans. The Association currently retains the servicing rights on all loans sold in order to generate fee income and reinforce its commitment to customer service. These one- to four-family residential mortgage real estate loans were underwritten generally to Fannie Mae guidelines and comply with applicable federal, state and local laws. At the time of the closing of these loans the Association owned the loans and subsequently sold them to Fannie Mae and others providing normal and customary representations and warranties, including representations and warranties related to compliance, generally with Fannie Mae underwriting standards. At the time of sale, the loans were free from encumbrances except for the mortgages filed by the Association which, with other underwriting documents, were subsequently assigned and delivered to Fannie Mae and others. At September 30, 2010, substantially all of the loans serviced for Fannie Mae and others were performing in accordance with their contractual terms and management believes that it has no material repurchase obligations associated with these loans. For the fiscal

years ended September 30, 2010 and 2009, the Association recognized servicing fees, net of amortization, related to these servicing rights of \$16.9 million and \$16.5 million, respectively. As of September 30, 2010 and 2009, the principal balance of loans serviced for others totaled \$7.04 billion and \$7.50 billion, respectively.

The Association currently offers Smart Rate adjustable-rate mortgage loan products secured by residential properties with interest rates that are fixed for an initial period of three or five years, after which the interest rate generally resets every year based upon a contractual spread or margin above the Prime Rate as published in the Wall Street Journal. These adjustable-rate mortgages provide the borrower with an attractive rate reset option, based on the Association's then current lending rates. Prior to July 2010, the Association's adjustable-rate mortgage loan products secured by residential properties offered interest rates that were fixed for an initial period ranging from one year to five years, after which the interest rate generally reset every year based upon a contractual spread or margin above the average yield on U.S. Treasury securities, adjusted to a constant maturity of one year, as published weekly by the Federal Reserve Board (Traditional ARM). All of the Association's adjustable-rate mortgage loans are subject to periodic and lifetime limitations on interest rate changes. Prior to March 11, 2009, the Association offered mortgage loans where the borrower paid only interest for a portion of the loan term (Interest-only ARM). All of its adjustable-rate mortgage loans with initial fixed-rate periods of one, three or five years have initial and periodic caps of two percentage points on interest rate changes, with a cap of six percentage points for the life of the loan for Traditional ARM and Interest-only ARM loans and five percentage points for the life of Smart Rate loans. Previously, the Association also offered Traditional ARM loans with an initial fixed-rate period of seven years. Loans originated under that program, which was discontinued in August 2007, had an initial cap of five percentage points on the changes in interest rate, with a two percentage point cap on subsequent changes and a cap of five percentage points for the life of the loan. Many of the borrowers who select adjustable-rate mortgage loans have shorter-term credit needs than those who select long-term, fixed-rate mortgage loans. The Association will permit borrowers to convert non-Smart Rate adjustable-rate mortgage loans into fixed-rate mortgage loans at no cost to the borrower. The Association does not offer Option ARM loans, where borrowers can pay less than the interest owed on their loan, resulting in an increased principal balance during the life of the loan.

Adjustable-rate mortgage loans generally present different credit risks than fixed-rate mortgage loans primarily because the underlying debt service payments of the borrowers increase as interest rates increase, thereby increasing the potential for default. Interest-only loans present different credit risks than fully amortizing loans, as the principal balance of the loan does not decrease during the interest-only period. As a result, the Association's exposure to loss of principal in the event of default does not decrease during this period. Adjustable rate, interest-only, loans comprise less than 2% of our residential loans.

The Association requires title insurance on all of its residential real estate mortgage loans, and the Association also requires that borrowers maintain fire and extended coverage casualty insurance (and, if appropriate, flood insurance) in an amount at least equal to the lesser of the loan balance or the replacement cost of the improvements. A majority of its residential real estate mortgage loans have a mortgage escrow account from which disbursements are made for real estate taxes and flood insurance. The Association does not conduct environmental testing on residential real estate mortgage loans unless specific concerns for hazards are identified by the appraiser used in connection with the origination of the loan.

Home Equity Loans and Home Equity Lines of Credit. Following a series of progressively restrictive modifications with respect to geography, qualification requirements and features, effective June 28, 2010 and except for bridge loans as described later in this paragraph, the Association discontinued offering home equity loans and home equity lines of credit. Prior to June 28, 2010, the Association offered home equity loans and home equity lines of credit, which were primarily secured by a second mortgage on residences. The Association also offered a home equity lending product that was secured by a third mortgage, although the Association only originated this loan to borrowers where the Association also held the second mortgage. At September 30, 2010, home equity loans totaled \$250.8 million, or 2.7% of total loans receivable, and funds advanced under home equity lines of credit totaled \$2.59 billion, or 27.6% of total loans receivable. Additionally, at September 30, 2010, the unadvanced amounts of home equity lines of credit totaled \$2.12 billion. The only home equity lending

product that the Association continues to offer are bridge loans, where a borrower can utilize the existing equity in their current home to fund the purchase of a new home before the current home is sold. As of September 30, 2010, bridge loans totaled \$9.8 million, or 0.1% of total loans receivable.

When offered, the underwriting standards for home equity loans and home equity lines of credit included an evaluation of the applicant's credit history, employment and income verification, an assessment of the applicant's ability to meet existing obligations and payments on the proposed loan and the value of the collateral securing the loan. Prior to June 28, 2010, through a series of modifications and program adjustments, the home equity lending parameters became increasingly restrictive. From a geographic perspective, product offerings peaked in 2008 when offers were extended (primarily via direct mail) to targeted borrowers in 18 states. Generally, the least restrictive qualification and the most attractive product features from a borrower's perspective were in place during portions of fiscal 2006 and 2007, when combined loan-to-value ratios of up to 89.99% were permitted, minimum credit scores extended to 620, maximum loan amounts reached \$250,000 and pricing for lines of credit reached Prime minus 1.01% when drawn balances exceeded \$50,000. The Association originated its home equity loans and home equity lines of credit without application fees (except for bridge loans) or borrower-paid closing costs. Home equity loans were offered with fixed interest rates, were fully amortizing and had terms of up to 15 years. The Association's home equity lines of credit were offered with adjustable rates of interest indexed to the prime rate, as reported in *The Wall Street Journal*. The Association's Lowest Rate Guarantee program provided that, subject to the terms and conditions of the guarantee program, if a loan applicant or current home equity line of credit borrower found and qualified for a better interest rate on a similar product with another lender, the Association would offer a lower rate or, if the borrower closed under the rate and terms presented with respect to the other lender, the Association paid the loan applicant or borrower \$1,000.

Bridge loans are originated for a one-year term, with no prepayment penalties. These loans have fixed interest rates, and are currently limited to a combined 80% loan-to-value ratio (first and second mortgage liens). The Association charges a closing fee with respect to bridge loans.

Construction Loans. The Association originates construction loans for the purchase of developed lots and for the construction of single-family residences. Construction loans are offered to individuals for the construction of their personal residences by a qualified builder (construction/permanent loans), and to qualified builders (builder loans). At September 30, 2010, construction loans totaled \$100.4 million, or 1.1% of total loans receivable. At September 30, 2010, the unadvanced portion of these construction loans totaled \$45.0 million.

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 80%. At September 30, 2010, the Association's construction/permanent loans totaled \$69.8 million, or 0.7% of total loans receivable.

The Association's builder loans consist of loans for homes that have been pre-sold as well as loans to developers that build homes before a buyer has been identified. The Association does not make land loans to developers for the acquisition and development of raw land. Construction loans to developers are currently limited to an 80% loan-to-completed-appraised value ratio for homes that are under contract for purchase and a 70% loan-to-completed-appraised value ratio for loans where no buyer has been identified. The interest rates are based on and adjust with the prime rate of interest, and are for terms of up to two years. As of September 30, 2010, the Association's builder loans totaled \$30.6 million, or 0.3% of total loans receivable.

Before making a commitment to fund a construction loan, the Association requires an appraisal of the property by an independent licensed appraiser. The Association generally also reviews and inspects each property before disbursement of funds during the term of the construction loan.

Construction financing generally involves greater credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction cost proves to be inaccurate, the Association 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 proves to be 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. This is more likely to occur when home prices are falling, like our current economic environment.

Loan Originations, Purchases, Sales, Participations and Servicing. Lending activities are conducted primarily by the Association's loan personnel (all of whom are salaried employees) operating at our main and branch office locations and at our loan production offices. All loans that the Association originates are underwritten pursuant to its policies and procedures, which essentially incorporates Fannie Mae underwriting guidelines to the extent applicable subject to the discussion below. The Association originates both adjustable-rate and fixed-rate loans and advertises extensively throughout its market area. Its ability to originate fixed- or adjustable-rate loans is dependent upon the relative customer demand for such loans, which is affected by current market interest rates as well as anticipated future market interest rates. The Association's loan origination and sales activity may be adversely affected by a rising interest rate environment or economic recession, which typically results in decreased loan demand. Most of the Association's residential real estate mortgage loan originations are generated by its in-house loan representatives, by referrals from existing or past customers, by referrals from local builders and real estate brokers, from calls to its telephone call center and from the internet. Since 2005, the Association has maintained a relationship with only one mortgage broker, which is affiliated with a national builder. During the fiscal year ended September 30, 2010, the Association originated \$26.3 million of loans through this relationship. All such loans are underwritten to conform to the Association's loan underwriting policies and procedures. In October 2010, this relationship was suspended due to limited activity.

The Association decides whether to retain the loans that it originates, sell loans in the secondary market or securitize loans after evaluating current and projected market interest rates, its interest rate risk objectives, its liquidity needs and other factors. The Association securitized and sold \$1.03 billion of residential real estate mortgage loans (all fixed-rate loans, and primarily with 30-year terms) during the fiscal year ended September 30, 2010. As described in the preceding *Residential Real Estate Mortgage Loans* section, effective July 1, 2010, Fannie Mae, the Association's primary loan investor, implemented certain loan origination requirement changes affecting loan eligibility that we did not adopt. Accordingly, the Association's ability to reduce interest rate risk via our traditional loan sales of newly originated longer-term fixed rate residential loans is limited until the Association either changes its loan origination processes or Fannie Mae, Freddie Mac or other market participants, revise their loan eligibility standards. Otherwise, future sales of fixed-rate mortgage loans will predominately be limited to those loans that have established payment histories, strong borrower credit profiles and are supported by adequate collateral values. Inasmuch as we have not changed our traditional underwriting standards, the Association had no loans committed for sale in the secondary market at September 30, 2010. The fixed-rate mortgage loans that the Association originated and retained during the fiscal year ended September 30, 2010 consisted primarily of loans with 30-year terms.

Historically, the Association has retained the servicing rights on all residential real estate mortgage loans that it has sold, and intends to continue this practice in the future. At September 30, 2010, the Association serviced loans owned by others with a principal balance of \$7.04 billion, of which \$8.4 million of loans sold to Fannie Mae remain subject to recourse. All recourse sales occurred prior to the year 2000. 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. The Association retains a portion of the interest paid by the borrower on the loans it services as consideration for its servicing activities. The Association did not enter into any loan participations during the fiscal year ended September 30, 2010 and does not expect to do so in the near future.

Loan Approval Procedures and Authority. The Association's lending activities follow written, non-discriminatory underwriting standards and loan origination procedures established by its board of directors. The loan approval process is intended to assess the borrower's ability to repay the loan and the value of the property that will secure the loan. To assess the borrower's ability to repay, the Association reviews the borrower's employment and credit history and information on the historical and projected income and expenses of the borrower.

The Association's policies and loan approval limits are established by its board of directors. The Association's board of directors has delegated authority to its Executive Committee (consisting of the Association's Chief Executive Officer and two directors) to review and assign lending authorities to certain individuals of the Association to consider and approve loans within their designated authority. Residential real estate mortgage loans and construction loans in amounts above \$650,000 require the approval of two individuals with designated underwriting authority. Loans in amounts below \$650,000 require the approval of one individual with designated underwriting authority.

The Association also maintains automated underwriting systems for point-of-sale approvals of residential real estate mortgage loans. Applications for loans that meet certain credit and income criteria may receive a credit approval subject to an appraisal of the subject property.

The Association requires independent third-party appraisals of real property. Appraisals are performed by independent licensed appraisers.

Non-performing Assets and Restructured Loans. Within 15 days of a borrower's delinquency, the Association attempts personal, direct contact with the borrower to determine the reason for the delinquency, to ensure that the borrower correctly understands the terms of the loan and to emphasize the importance of making payments on or before the due date. If necessary, subsequent late charges and delinquent notices are issued and the borrower's account will be monitored on a regular basis thereafter. The Association also mails system-generated reminder notices on a monthly basis. When a loan is more than 30 days past due, the Association attempts to contact the borrower and develop a plan of repayment. By the 90th day of delinquency, the Association may recommend foreclosure. By this date, if a repayment agreement has not been established, or if an agreement is established but is subsequently broken, the borrower's credit file is reviewed and, if considered necessary, information is updated or confirmed and the property securing the loan is re-evaluated. A summary report of all loans 30 days or more past due is provided to the Association's board of directors.

Loans are automatically placed on non-accrual status when payment of principal or interest is more than 90 days delinquent. Loans are also placed on non-accrual status if collection of principal or interest in full is in doubt or if the loan has been restructured. When loans are placed on a non-accrual status, unpaid accrued interest is fully reversed, and further income is recognized only to the extent received. The loan may be returned to accrual status if unpaid principal and interest are repaid so that the loan is less than 90 days delinquent.

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The table below sets forth the amounts and categories of our non-performing assets and troubled debt restructurings at the dates indicated.

	2010	2009	At September 30, 2008	2007	2006
	(Dollars in thousands)				
Non-accrual loans:					
Real estate loans:					
Residential non-Home Today	\$ 135,777	\$ 100,061	\$ 43,935	\$ 21,746	\$ 22,420
Residential Home Today	92,440	84,694	63,679	55,653	40,153
Home equity loans and lines of credit(1)	54,153	59,351	54,430	31,467	15,867
Construction	5,041	11,638	10,842	4,659	1,266
Other loans	1	1	0	0	3
Total non-accrual loans(2)(3)	287,412	255,745	172,886	79,709	