

Capitol Federal Financial Inc  
Form 10-Q  
August 19, 2010

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

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

or

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

Commission file number: 001-34814

Capitol Federal Financial, Inc.  
(Exact name of registrant as specified in its charter)

Employer	Maryland	27-2631712	(I.R.S.
	(State or other jurisdiction of incorporation or organization)		Identification No.)
Code)	700 Kansas Avenue, Topeka, Kansas (Address of principal executive offices)	66603 (Zip	

Registrant's telephone number, including area code:  
(785) 235-1341

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 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes  No

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

Large accelerated filer       Accelerated filer       Non-accelerated filer       Smaller Reporting Company   
(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

As of August 16, 2010, there were no shares of \$0.01 par value Capitol Federal Financial, Inc. Common Stock outstanding.

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Explanatory Note:

Capitol Federal Financial, Inc., a Maryland corporation (the “Registrant”), was organized to facilitate the “second-step” conversion of Capitol Federal Savings Bank (the “Bank”) from the mutual holding company structure to the stock holding company structure (the “Conversion”). The Conversion is expected to be consummated in the fourth quarter of fiscal year 2010, at which time the Registrant will become the holding company for the Bank and will own all of the issued and outstanding shares of the Bank’s common stock. As part of the Conversion, shares of the Registrant’s common stock will be issued and sold in an offering to certain depositors of the Bank and others and will also be issued in exchange for the currently issued and outstanding shares of Capitol Federal Financial, a federal corporation, the current mid-tier holding company for the Bank (“CFF”) held by persons other than Capitol Federal Savings Bank MHC (“MHC”). The Registrant filed a registration statement on Form S-1 (File No. 333-166578) with the Securities and Exchange Commission (the “SEC”) on May 6, 2010, which was declared effective by the SEC on July 9, 2010. The Conversion and related offering were conditionally approved by the Office of Thrift Supervision on July 9, 2010. Completion of the Conversion and related offering is subject to, among other things, the receipt of final regulatory approvals and approval by CFF’s shareholders and the members of Capitol Federal Savings Bank MHC. The information in this Form 10-Q is for CFF; certain information contained within may not be relevant for the Registrant. Separate financial statements for the Registrant have not been included in this report because the Registrant, which has not issued any shares and has engaged only in organizational activities to date, has no significant assets, contingent or other liabilities, equity, revenues or expenses. On July 8, 2010, the Registrant was capitalized with \$1 thousand.

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PART I -- FINANCIAL INFORMATION  
Item 1. Financial Statements  
CAPITOL FEDERAL FINANCIAL AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS (unaudited)  
(Dollars in thousands except per share data and amounts)

	June 30, 2010	September 30, 2009
ASSETS:	(Unaudited)	
Cash and cash equivalents (includes interest-earning deposits of \$64,070 and \$32,319)	\$75,886	\$41,154
Investment securities:		
Available-for-sale ("AFS") at estimated fair value (amortized cost of \$56,735 and \$235,185)	56,601	234,784
Held-to-maturity ("HTM") at amortized cost (estimated fair value of \$1,152,442 and \$248,929)	1,146,463	245,920
Mortgage-backed securities ("MBS"):		
AFS, at estimated fair value (amortized cost of \$1,048,106 and \$1,334,357)	1,106,815	1,389,211
HTM, at amortized cost (estimated fair value of \$542,761 and \$627,829)	513,808	603,256
Loans receivable, net (of allowance for loan losses ("ALLL") of \$15,677 and \$10,150)	5,316,172	5,603,965
Bank-owned life insurance ("BOLI")	54,350	53,509
Capital stock of Federal Home Loan Bank ("FHLB"), at cost	136,055	133,064
Accrued interest receivable	31,578	32,640
Premises and equipment, net	40,915	37,709
Real estate owned ("REO"), net	7,150	7,404
Prepaid federal insurance premium	22,285	--
Other assets	35,279	21,064
<b>TOTAL ASSETS</b>	<b>\$8,543,357</b>	<b>\$8,403,680</b>
LIABILITIES:		
Deposits	\$4,373,844	\$4,228,609
Advances from FHLB	2,396,637	2,392,570
Other borrowings, net	713,609	713,609
Advance payments by borrowers for taxes and insurance	31,737	55,367
Income taxes payable	1,440	6,016
Deferred income tax liabilities, net	35,098	30,970
Accounts payable and accrued expenses	30,992	35,241
<b>Total liabilities</b>	<b>7,583,357</b>	<b>7,462,382</b>
STOCKHOLDERS' EQUITY:		
Preferred stock (\$0.01 par value) 50,000,000 shares authorized; none issued	--	--
Common stock (\$0.01 par value) 450,000,000 shares authorized, 91,512,287 shares issued; 73,990,978 and 74,099,355 shares outstanding as of June 30, 2010 and September 30, 2009, respectively	915	915

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Additional paid-in capital	456,786	452,872
Unearned compensation, Employee Stock Ownership Plan (“ESOP”)	(6,553 )	(8,066 )
Unearned compensation, Recognition and Retention Plan (“RRP”)	(297 )	(330 )
Retained earnings	796,093	781,604
Accumulated other comprehensive income, net of tax	36,433	33,870
Less shares held in treasury (17,521,309 and 17,412,932 shares as of June 30, 2010 and September 30, 2009, respectively, at cost)	(323,377 )	(319,567 )
Total stockholders' equity	960,000	941,298
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$8,543,357</b>	<b>\$8,403,680</b>

See accompanying notes to consolidated financial statements.

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## CAPITOL FEDERAL FINANCIAL AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(Dollars and share counts in thousands except per share data)

	For the Three Months Ended June 30,		For the Nine Months Ended June 30,	
	2010	2009	2010	2009
<b>INTEREST AND DIVIDEND INCOME:</b>				
Loans receivable	\$ 68,990	\$ 76,745	\$ 213,831	\$ 230,907
MBS	16,864	24,211	56,245	75,701
Investment securities	4,565	1,279	10,850	3,560
Capital stock of FHLB	1,005	793	2,991	2,351
Cash and cash equivalents	61	50	162	167
Total interest and dividend income	91,485	103,078	284,079	312,686
<b>INTEREST EXPENSE:</b>				
FHLB advances	24,417	25,307	73,535	81,505
Deposits	19,149	24,705	61,030	76,201
Other borrowings	7,032	7,144	21,090	21,978
Total interest expense	50,598	57,156	155,655	179,684
<b>NET INTEREST AND DIVIDEND INCOME</b>				
	40,887	45,922	128,424	133,002
<b>PROVISION FOR LOAN LOSSES</b>				
	1,816	3,112	8,131	5,768
<b>NET INTEREST AND DIVIDEND INCOME AFTER PROVISION FOR LOAN LOSSES</b>				
	39,071	42,810	120,293	127,234
<b>OTHER INCOME:</b>				
Retail fees and charges	4,681	4,671	13,617	13,271
Insurance commissions	573	528	1,908	1,892
Loan fees	670	564	1,925	1,730
Income from BOLI	351	262	842	887
Gain on securities, net	--	--	6,454	--
Gain on loans receivable, net	972	1,629	1,135	2,169
Other income, net	507	578	1,540	1,900
Total other income	7,754	8,232	27,421	21,849
<b>OTHER EXPENSES:</b>				
Salaries and employee benefits	10,858	10,715	32,197	32,447
Communications, information technology, and occupancy	3,703	3,936	11,499	11,428
Federal insurance premium	1,835	5,307	5,494	5,700
Advertising and promotional	1,295	1,704	4,276	5,393
Deposit and loan transaction costs	1,238	1,276	3,934	3,998
Regulatory and outside services	927	857	3,369	2,986

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Postage and office supplies	439	582	1,853	2,030
Other expenses, net	329	2,034	3,851	6,650
Total other expenses	20,624	26,411	66,473	70,632
INCOME BEFORE INCOME TAX				
EXPENSE	26,201	24,631	81,241	78,451
INCOME TAX EXPENSE	9,443	9,155	28,848	28,991
NET INCOME	\$ 16,758	\$ 15,476	\$ 52,393	\$ 49,460
Basic earnings per common share	\$ 0.23	\$ 0.21	\$ 0.72	\$ 0.68
Diluted earnings per common share	\$ 0.23	\$ 0.21	\$ 0.72	\$ 0.68
Dividends declared per public share	\$ 0.50	\$ 0.50	\$ 1.79	\$ 1.61
Basic weighted average common shares	73,273,472	73,172,822	73,251,516	73,116,212
Diluted weighted average common shares	73,297,126	73,232,496	73,273,409	73,189,501

See accompanying notes to consolidated financial statements.



CAPITOL FEDERAL FINANCIAL AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
(Unaudited)  
(Dollars in thousands)

	Common Stock	Additional Paid-In Capital	Unearned Compensation ESOP	Unearned Compensation RRP	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders' Equity
Balance at October 1, 2009	\$915	\$452,872	\$ (8,066 )	\$ (330 )	\$781,604	\$ 33,870	\$(319,567)	\$ 941,298
Comprehensive income:								
Net income					52,393			52,393
Other comprehensive income:								
Changes in unrealized gain/losses on securities AFS, net of deferred income taxes of \$1,559						2,563		2,563
Total comprehensive income								54,956
ESOP activity, net		3,514	1,513					5,027
RRP activity, net		122		(163 )			47	6
Stock based compensation - stock options and RRP		174		196				370
Acquisition of treasury stock							(4,019 )	(4,019 )
Stock options exercised		104					162	266
Dividends on common stock to stockholders \$1.79 per public share					(37,904 )			(37,904 )
Balance at June 30, 2010	\$915	\$456,786	\$ (6,553 )	\$ (297 )	\$796,093	\$ 36,433	\$(323,377)	\$ 960,000

See accompanying notes to consolidated financial statements.

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CAPITOL FEDERAL FINANCIAL AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)  
(Dollars in thousands)

	For the Nine Months Ended	
	June 30,	
	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 52,393	\$ 49,460
Adjustments to reconcile net income to net cash provided by operating activities:		
FHLB stock dividends	(2,991 )	(2,351 )
Provision for loan losses	8,131	5,768
Originations of loans receivable held-for-sale ("LHFS")	(32,811 )	(858 )
Proceeds from sales of LHFS	28,505	97,838
Amortization and accretion of premiums and discounts on MBS and investment securities	4,449	1,377
Depreciation and amortization of premises and equipment	3,487	3,751
Amortization of deferred amounts related to FHLB advances, net	4,942	2,208
Common stock committed to be released for allocation - ESOP	5,027	6,166
Stock based compensation - stock options and RRP	370	475
Gain on the sale of trading securities received in the loan swap transaction	(6,454 )	--
Changes in:		
Prepaid federal insurance premium	(22,285 )	--
Accrued interest receivable	1,062	876
Other assets, net	(9,908 )	620
Income taxes payable/receivable	(2,002 )	1,840
Accounts payable and accrued expenses	(4,249 )	1,010
Net cash provided by operating activities	27,666	168,180
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from sale of trading securities received in the loan swap transaction	199,144	--
Proceeds from maturities or calls of investment securities AFS	177,069	45,032
Purchases of investment securities AFS	--	(255,046 )
Proceeds from maturities or calls of investment securities HTM	153,115	39,600
Purchases of investment securities HTM	(1,055,442)	(10,116 )
Principal collected on MBS AFS	284,951	227,574
Purchases of MBS AFS	--	(169,452 )
Principal collected on MBS HTM	94,496	125,176
Purchases of MBS HTM	(5,032 )	(3,217 )
Proceeds from the redemption of capital stock of FHLB	--	3,688
Purchases of capital stock of FHLB	--	(9,002 )
Loan originations, net of principal collected	45,798	(196,002 )
Loan purchases, net of principal collected	30,960	(133,849 )
Net deferred fee activity	131	1,330
Purchases of premises and equipment	(6,735 )	(8,944 )
Proceeds from sales of REO	9,538	6,047
Net cash used in investing activities	(72,007 )	(337,181 )

(Continued)

	For the Nine Months Ended June 30,	
	2010	2009
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Dividends paid	(37,904 )	(33,621 )
Deposits, net of withdrawals	145,235	251,368
Proceeds from advances/line of credit from FHLB	300,000	1,561,102
Repayments on advances/line of credit from FHLB	(300,000 )	(1,561,102)
Deferred FHLB prepayment penalty	(875 )	(38,388 )
Change in advance payments by borrowers for taxes and insurance	(23,630 )	(22,801 )
Acquisitions of treasury stock	(4,019 )	(2,426 )
Stock options exercised	178	1,316
Excess tax benefits from stock options	88	516
Net cash provided by financing activities	79,073	155,964
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>34,732</b>	<b>(13,037 )</b>
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	41,154	87,138
End of period	\$75,886	\$74,101
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Income tax payments	\$30,757	\$27,116
Interest payments, net of interest credited to deposits	\$90,053	\$103,229
<b>SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>		
Loans transferred to REO	\$9,014	\$7,320
Transfer of loans receivable to LHFS, net	\$--	\$94,672
Swap of loans for trading securities	\$193,889	\$--

(Concluded)

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements (Unaudited)

1. Basis of Financial Statement Presentation

The accompanying consolidated financial statements of Capitol Federal Financial and subsidiaries (the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2009, filed with the Securities and Exchange Commission (“SEC”). Interim results are not necessarily indicative of results for a full year. In preparing the financial statements, management is required 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 and revenues and expenses during the reporting periods. Significant estimates include the ALLL, other-than-temporary declines in the fair value of securities, and fair value measurements. Actual results could differ from those estimates. See “Item 2- Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies.”

The Board of Directors of Capitol Federal Savings Bank MHC (“MHC”), the Company and Capitol Federal Savings Bank (the “Bank”) adopted a Plan of Conversion and Reorganization (the “Plan”) on May 5, 2010. Pursuant to the Plan, MHC will convert from the mutual holding company form of organization to a stock form of organization. MHC will be merged into the Company, and MHC will no longer exist. Pursuant to the Plan, the Company, which owns 100% of the Bank, also will be succeeded by a new Maryland corporation, named Capitol Federal Financial, Inc. As part of the conversion, MHC’s ownership interest of the Company will be offered for sale in a public offering. The existing publicly held shares of the Company, which represents the remaining ownership interest in the Company, will be exchanged for new shares of common stock of Capitol Federal Financial, Inc., the new Maryland corporation. The exchange ratio will ensure that immediately after the conversion and public offering, the public stockholders of the Company will own the same aggregate percentage of Capitol Federal Financial, Inc. common stock that they owned of the Company common stock immediately prior to that time. When the conversion and public offering are completed, all of the outstanding capital stock of the Bank will be owned by Capitol Federal Financial, Inc. and all of the outstanding capital stock of Capitol Federal Financial, Inc. will be owned by the public. The conversion and reorganization is expected to be completed by the end of fiscal year 2010, subject to the receipt of final regulatory approvals and approval by the Company’s shareholders and the members of MHC.

The Plan provides for the establishment, upon the completion of the reorganization, of special “liquidation accounts” at Capitol Federal Financial, Inc. and at the Bank for the benefit of certain depositors of the Bank in an amount equal to MHC’s ownership interest in the retained earnings of the Company as of the date of the latest balance sheet contained in the prospectus for the public offering. Following the completion of the reorganization, under the rules of the Office of Thrift Supervision (“OTS”), neither Capitol Federal Financial, Inc. nor the Bank, will be permitted to pay dividends on its capital stock to its stockholders, if stockholders’ equity would be reduced below the amount of its liquidation account.

In addition, Capitol Federal Financial, Inc. intends to fund a \$40.0 million cash contribution to the Bank’s charitable foundation in connection with the conversion.

Direct costs of the conversion and public offering will be deferred and reduce the proceeds from the shares sold in the public offering. If the conversion and public offering are not completed, all costs will be charged to expense in the period in which the public offering is terminated. As of June 30, 2010, the Company had deferred \$3.3 million in

costs related to the offering.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, the Bank and Capitol Federal Financial, Inc. The Bank has a wholly-owned subsidiary, Capitol Funds, Inc. Capitol Funds, Inc. has a wholly-owned subsidiary, Capitol Federal Mortgage Reinsurance Company. All intercompany accounts and transactions have been eliminated.

## 2. Recent Accounting Pronouncements

Effective October 1, 2009, the Company adopted new authoritative accounting guidance under Accounting Standards Codification (“ASC”) 260, Earnings Per Share, which provides that unvested share-based payment awards containing nonforfeitable rights to dividends or dividend equivalents are participating securities and should be included in the computation of earnings per share (“EPS”) pursuant to the two-class method. The Company determined that its unvested RRP awards are participating securities. This new guidance requires retrospective adjustment to all prior-period EPS data presented. The Company has participating securities related to the Company’s stock incentive plans in the form of unvested restricted common shares. However, these participating securities do not have an impact on the Company’s EPS.

In June 2009, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 166, Accounting for Transfers of Financial Assets an Amendment of FASB Statement No. 140. SFAS No. 166 was codified into ASC 860, Transfers of Servicing Assets by Accounting Standards Update (“ASU”) 2009-16. The objective of SFAS No. 166 is to improve the relevance, representational faithfulness, and comparability of the information provided in the financial statements related to the transfer of financial assets; the effects of a transfer on the company’s financial position, financial performance and cash flows; and a transferor’s continuing involvement in transferred financial assets. SFAS No. 166 is effective for financial asset transfers occurring after the beginning of an entity’s first fiscal year that begins after November 15, 2009, which for the Company is October 1, 2010. Early adoption is prohibited. The Company has not yet completed its assessment of the impact of SFAS No. 166.

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R). SFAS No. 167 was codified into ASC 810, Consolidation by ASU 2009-17. SFAS No. 167 does not change many of the key principles for determining whether an entity is a variable interest entity consistent with the ASC on “Consolidation.” SFAS No. 167 does amend many important provisions of the existing guidance on “Consolidation.” SFAS No. 167 is effective as of the beginning of the first fiscal year that begins after November 15, 2009, which for the Company is October 1, 2010. Early adoption is prohibited. The Company has not yet completed its assessment of the impact of SFAS No. 167.

In January 2010, the FASB issued ASU 2010-06, Improving Disclosures About Fair Value Measurements, which amends ASC 820-10 to require new disclosures about transfers in and out of Level 1 and Level 2 fair value measurements and the roll forward of activity in Level 3 fair value measurements. ASU 2010-06 also clarifies existing disclosure requirements regarding the level of disaggregation of each class of assets and liabilities within a line item in the statement of financial condition and clarifies that a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements that fall in either Level 2 or Level 3 fair value measurements. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the new disclosures about the roll forward of activity in Level 3 fair value measurements which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. Since the provisions of ASU 2010-06 are disclosure related, the Company’s adoption of this guidance did not have an impact on its financial condition or results of operations.

In February 2010, the FASB issued ASU 2010-09, Amendments to Certain Recognition and Disclosure Requirements, which amends ASC 855, Subsequent Events to address implementation issues of ASC 855. ASU 2010-09 requires SEC filers to evaluate subsequent events through the date the financial statements are issued and exempts SEC filers from disclosing the date through which subsequent events have been evaluated. The ASU was effective immediately for the Company. Since the provisions of ASU 2010-09 are disclosure related, the Company’s adoption of this guidance did not have an impact on its financial condition or results of operations.



## 3. Earnings Per Share

The Company accounts for the 3,024,574 shares acquired by its ESOP and the shares awarded pursuant to its RRP in accordance with ASC 260, which requires that unvested RRP awards that contain nonforfeitable rights to dividends be treated as participating securities in the computation of EPS pursuant to the two-class method. The two-class method is an earnings allocation that determines EPS for each class of common stock and participating security. Shares acquired by the ESOP are not considered in the basic average shares outstanding until the shares are committed for allocation or vested to an employee's individual account.

	For the Three Months Ended		For the Nine Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
	(in thousands, except share and per share data)			
Net income (1)	\$ 16,758	\$ 15,476	\$ 52,393	\$ 49,460
Average common shares outstanding	73,172,098	73,071,448	73,200,737	73,065,433
Average committed ESOP shares outstanding	101,374	101,374	50,779	50,779
Total basic average common shares outstanding	73,273,472	73,172,822	73,251,516	73,116,212
Effect of dilutive RRP shares	2,029	3,842	3,182	5,626
Effect of dilutive stock options	21,625	55,832	18,711	67,663
Total diluted average common shares outstanding	73,297,126	73,232,496	73,273,409	73,189,501
Net EPS:				
Basic	\$ 0.23	\$ 0.21	\$ 0.72	\$ 0.68
Diluted	\$ 0.23	\$ 0.21	\$ 0.72	\$ 0.68
Antidilutive stock options and RRP, excluded from the diluted average common shares outstanding calculation	101,850	74,050	219,252	74,050

(1) Net income available to participating securities (unvested RRP shares) was inconsequential for the three and nine month periods ended June 30, 2010 and June 30, 2009.



#### 4. Fair Value of Financial Instruments

Fair Value Measurements - ASC 820, Fair Value Measurements and Disclosures, defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. The Company did not have any liabilities that were measured at fair value at June 30, 2010. The Company's AFS securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets or liabilities on a non-recurring basis, such as REO and impaired loans. These non-recurring fair value adjustments involve the application of lower-of-cost-or-fair value accounting or write-downs of individual assets.

In accordance with ASC 820, the Company groups its assets at fair value in three levels, based on the markets in which the assets are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 — Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 — Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 — Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company's own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models, and similar techniques. The results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability.

The Company bases its fair values on the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. As required by ASC 820, the Company maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value.

The following is a description of valuation methodologies used for assets measured at fair value on a recurring basis.

##### AFS Securities

The Company's AFS securities portfolio is carried at estimated fair value, with any unrealized gains and losses, net of taxes, reported as accumulated other comprehensive income/loss in stockholders' equity. The Company's major security types based on the nature and risks of the securities are included in the table below. The majority of the securities within the AFS portfolio are issued by U.S. government-sponsored enterprises ("GSEs"). The fair values for all AFS securities are based on quoted prices for similar securities. Various modeling techniques are used to determine pricing for the Company's securities, including option pricing and discounted cash flow models. The inputs to these models may include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, benchmark securities, bids, offers and reference data. The Company is responsible for the valuation process and as part of this process may use data from outside sources in establishing fair value. The Company performs due diligence to understand the inputs used or how the data was calculated or derived. The Company corroborates the reasonableness

of the valuation process. There are some AFS securities in the AFS portfolio that have significant unobservable inputs requiring the independent pricing services to use some judgment in pricing the related securities. These AFS securities are classified as Level 3. All other AFS securities are classified as Level 2.

The following table provides the level of valuation assumption used to determine the carrying value of the Company's assets measured at fair value on a recurring basis, which consists of AFS securities, at June 30, 2010.

Quoted Prices in Active Markets	Significant	Significant
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