

Capitol Federal Financial Inc  
Form 10-K  
November 29, 2016

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended September 30, 2016

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)

Maryland

(State or other jurisdiction of incorporation or organization)

700 South Kansas Avenue, Topeka, Kansas

(Address of principal executive offices)

27-2631712

(I.R.S. Employer Identification No.)

66603

(Zip Code)

Registrant's telephone number, including area code:

(785) 235-1341

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 Each 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 (§ 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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the 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 the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of

the Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant, computed by reference to the average of the closing bid and asked price of such stock on the NASDAQ Stock Market as of March 31, 2016, was \$1.79 billion.

As of November 22, 2016, there were issued and outstanding 137,883,847 shares of the Registrant's common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Part III of Form 10-K - Portions of the proxy statement for the Annual Meeting of Stockholders for the year ended September 30, 2016.

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Private Securities Litigation Reform Act-Safe Harbor Statement

Capitol Federal Financial, Inc. (the "Company"), and Capitol Federal Savings Bank ("Capitol Federal Savings" or the "Bank"), may from time to time make written or oral "forward-looking statements", including statements contained in documents filed or furnished by the Company with the Securities and Exchange Commission ("SEC"). These forward-looking statements may be included in this Annual Report on Form 10-K and the exhibits attached to it, in the Company's reports to stockholders, in the Company's press releases, and in other communications by the Company, which are made in good faith by us pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements include statements about our beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions, which are subject to significant risks and uncertainties, and are subject to change based on various factors, some of which are beyond our control. The words "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan" and similar expressions are intended to identify forward-looking statements. The following factors, among others, could cause our future results to differ materially from the beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions expressed in the forward-looking statements:

- our ability to maintain overhead costs at reasonable levels;
- our ability to originate and purchase a sufficient volume of one- to four-family loans in order to maintain the balance of that portfolio at a level desired by management;
- our ability to invest funds in wholesale or secondary markets at favorable yields compared to the related funding source;
- our ability to access cost-effective funding;
- fluctuations in deposit flows;
- the future earnings and capital levels of the Bank and the continued non-objection by our primary federal banking regulators, to the extent required, to distribute capital from the Bank to the Company, which could affect the ability of the Company to pay dividends in accordance with its dividend policy;
- the strength of the U.S. economy in general and the strength of the local economies in which we conduct operations, including areas where we have purchased large amounts of correspondent loans;
- changes in real estate values, unemployment levels, and the level and direction of loan delinquencies and charge-offs may require changes in the estimates of the adequacy of the allowance for credit losses ("ACL"), which may adversely affect our business;
- increases in non-performing assets, which may require the Bank to increase the ACL, charge-off loans and incur elevated collection and carrying costs related to such non-performing assets;
- results of examinations of the Bank and the Company by their respective primary federal banking regulators, including the possibility that the regulators may, among other things, require us to increase our ACL;
- changes in accounting principles, policies, or guidelines;
- the effects of, and changes in, monetary and interest rate policies of the Board of Governors of the Federal Reserve System ("FRB");
- the effects of, and changes in, trade and fiscal policies and laws of the United States government;
- the effects of, and changes in, foreign and military policies of the United States government;
- inflation, interest rate, market, monetary, and currency fluctuations;
- the timely development and acceptance of our new products and services and the perceived overall value of these products and services by users, including the features, pricing, and quality compared to competitors' products and services;
- the willingness of users to substitute competitors' products and services for our products and services;
- our success in gaining regulatory approval of our products and services and branching locations, when required;
- the impact of changes in financial services laws and regulations, including laws concerning taxes, banking, securities, consumer protection and insurance and the impact of other governmental initiatives affecting the financial services

industry;

• implementing business initiatives may be more difficult or expensive than anticipated;

• significant litigation;

• technological changes;

• acquisitions and dispositions;

• changes in consumer spending, borrowing and saving habits; and

• our success at managing the risks involved in our business.

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This list of important factors is not all inclusive. We do not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company or the Bank.

## PART I

As used in this Form 10-K, unless we specify otherwise, "the Company," "we," "us," and "our" refer to Capitol Federal Financial, Inc. a Maryland corporation. "Capitol Federal Savings," and "the Bank," refer to Capitol Federal Savings Bank, a federal savings bank and the wholly-owned subsidiary of Capitol Federal Financial, Inc.

### Item 1. Business

#### General

The Company is a Maryland corporation that was incorporated in April 2010. The Company's common stock is traded on the Global Select tier of the NASDAQ Stock Market under the symbol "CFFN."

The Bank is a wholly-owned subsidiary of the Company and is a federally chartered and insured savings bank headquartered in Topeka, Kansas. The Bank is examined and regulated by the Office of the Comptroller of the Currency (the "OCC"), its primary regulator, and its deposits are insured up to applicable limits by the Deposit Insurance Fund ("DIF"), which is administered by the Federal Deposit Insurance Corporation ("FDIC"). We primarily serve the metropolitan areas of Topeka, Wichita, Lawrence, Manhattan, Emporia and Salina, Kansas and a portion of the metropolitan area of greater Kansas City through 37 traditional and 10 in-store branches. The Company, as a savings and loan holding company, is examined and regulated by the FRB.

We have been, and intend to continue to be, a community-oriented financial institution offering a variety of financial services to meet the needs of the communities we serve. We attract retail deposits from the general public and invest those funds primarily in permanent loans secured by first mortgages on owner-occupied, one- to four-family residences. We also originate consumer loans primarily secured by mortgages on one- to four-family residences, originate and participate in loans with other lenders that are secured by commercial real estate, and invest in certain investment securities and mortgage-backed securities ("MBS") using funding from retail deposits, brokered and public unit deposits, Federal Home Loan Bank Topeka ("FHLB") borrowings, and repurchase agreements. We offer a variety of deposit accounts having a wide range of interest rates and terms, which generally include savings accounts, money market accounts, interest-bearing and non-interest-bearing checking accounts, and certificates of deposit with terms ranging from 91 days to 96 months. Our revenues are derived principally from interest on loans, MBS, investment securities, and FHLB stock.

The Company is significantly affected by prevailing economic conditions, including federal monetary and fiscal policies and federal regulation of financial institutions. Retail deposit balances are influenced by a number of factors, including interest rates paid on competing investment products, the level of personal income, and the personal rate of savings within our market areas. Lending activities are influenced by the demand for housing and other loans, our loan underwriting guidelines compared to those of our competitors, as well as interest rate pricing competition from other lending institutions.

Our executive offices are located at 700 South Kansas Avenue, Topeka, Kansas 66603, and our telephone number at that address is (785) 235-1341.

#### Available Information

Our Internet website address is [www.capfed.com](http://www.capfed.com). Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports can be obtained free of charge from our website. These reports are available on our website as soon as reasonably practicable after they are electronically filed with or furnished to the SEC. These reports are also available on the SEC's website at <http://www.sec.gov>.



### Market Area and Competition

Our corporate office is located in Topeka, Kansas. We currently have a network of 47 branches (37 traditional branches and 10 in-store branches) located in nine counties throughout Kansas and three counties in Missouri. We primarily serve the metropolitan areas of Topeka, Wichita, Lawrence, Manhattan, Emporia, and Salina, Kansas and a portion of the metropolitan area of greater Kansas City. In addition to providing full service banking offices, we provide our customers mobile banking, telephone banking and bill payment services, and online banking and bill payment services. We also have a call center which operates on extended hours.

The Bank ranked third in deposit market share, at 6.23%, in the state of Kansas as reported in the June 30, 2016 FDIC "Summary of Deposits - Market Share Report." The first and second ranked institutions had a 15.06% and a 7.00% deposit market share, respectively. The institution with 15.06% of deposit market share is primarily an Internet-based institution with only one physical location in Kansas. Deposit market share is measured by total deposits, without consideration for type of deposit. We do not offer commercial deposit accounts, while many of our competitors have both commercial and retail deposits in their total deposit base. Some of our competitors also offer products and services that we do not, such as trust services and private banking, which may add to their total deposits. Consumers also have the ability to utilize online financial institutions and investment brokerages that are not confined to any specific market area. Management considers our well-established retail banking network together with our reputation for financial strength and customer service to be major factors in our success at attracting and retaining customers in our market areas.

The Bank consistently has been one of the top one- to four-family lenders with regard to mortgage loan origination volume in the state of Kansas. Through our strong relationships with real estate agents and marketing efforts, which reflect our reputation and pricing, we attract mortgage loan business from walk-in customers, customers that apply online, and existing customers. Competition in originating one- to four-family loans primarily comes from other savings institutions, commercial banks, credit unions, and mortgage bankers. Other savings institutions, commercial banks, credit unions, and finance companies provide vigorous competition in consumer lending.

### Lending Practices and Underwriting Standards

General. Originating and purchasing loans secured by one- to four-family residential properties is the Bank's primary lending business, resulting in a loan concentration in residential first mortgage loans located in Kansas and Missouri. The Bank also originates consumer loans and construction loans secured by residential properties, and originates and participates in commercial real estate loans.

One- to Four-Family Residential Real Estate Lending. The Bank originates and services one- to four-family loans that are not guaranteed or insured by the federal government, and purchases one- to four-family loans, on a loan-by-loan basis, from a select group of correspondent lenders.

### Originated Loans

While the Bank originates both fixed- and adjustable-rate loans, our origination volume is dependent upon customer demand for loans in our market areas. Demand is affected by the local housing market, competition, and the interest rate environment. During fiscal years 2016 and 2015, the Bank originated and refinanced \$663.3 million and \$697.1 million of one- to four-family loans, respectively.

### Correspondent Purchased Loans

The Bank purchases one- to four-family loans, on a loan-by-loan basis, from a select group of correspondent lenders. Loan purchases enable the Bank to attain geographic diversification in the loan portfolio. At September 30, 2016, the Bank had correspondent lending relationships in 28 states and the District of Columbia. During fiscal years 2016 and 2015, the Bank purchased \$662.8 million and \$651.0 million, respectively, of one- to four-family loans from correspondent lenders. We generally pay a premium of 0.50% to 1.0% of the loan balance to purchase these loans, and we pay 1.0% of the loan balance to purchase the servicing of these loans.



The Bank has an agreement with a third-party mortgage sub-servicer to provide loan servicing for loans originated by the Bank's correspondent lenders in certain states. The sub-servicer has experience servicing loans in the market areas in which the Bank purchases loans and services the loans according to the Bank's servicing standards, which is intended to allow the Bank greater control over servicing and reporting and help maintain a standard of loan performance.

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### Bulk Purchased Loans

The Bank has also purchased one- to four-family loans from correspondent and nationwide lenders in bulk loan packages. The last bulk loan package purchased by the Bank was in August 2012. The Bank no longer purchases bulk loan packages. See "Part I, Item 1A. Risk Factors" for additional information regarding why the Bank no longer purchases bulk loan packages.

At September 30, 2016, \$239.1 million, or 57% of the Bank's bulk purchased loan portfolio, are loans guaranteed by the seller. The Bank believes the seller has the financial ability to repurchase or replace loans if any loans were to become delinquent. The Bank has not experienced any losses with this group of loans since the loan package was purchased in August 2012.

The servicing rights associated with bulk purchased loans were generally retained by the lender/seller for the loans purchased from nationwide lenders. The servicing with nationwide lenders is governed by a servicing agreement, which outlines collection policies and procedures, as well as oversight requirements, such as servicer certifications attesting to and providing proof of compliance with the servicing agreement.

### Underwriting

Full documentation to support an applicant's credit and income, and sufficient funds to cover all applicable fees and reserves at closing, are required on all loans. Generally, loans are underwritten according to the "ability to repay" and "qualified mortgage" standards, as issued by the Consumer Financial Protection Bureau ("CFPB"), with total debt-to-income ratios not exceeding 43% of a borrower's verified income. Information pertaining to the creditworthiness of the borrower generally consists of a summary of the borrower's credit history, employment stability, sources of income, assets, net worth, and debt ratios. The value of the subject property must be supported by an appraisal report prepared in accordance with our appraisal policy by either a staff appraiser or a fee appraiser, both of which are independent of the loan origination function and who are approved by our Board of Directors.

Loans over \$500 thousand must be underwritten by two senior underwriters. Loans over \$750 thousand must be approved by our Asset and Liability Management Committee ("ALCO"), while loans over \$1.5 million must be approved by our Board of Directors. For loans requiring ALCO and/or Board of Directors' approval, lending management is responsible for presenting to ALCO and/or the Board of Directors information about the creditworthiness of the borrower and the market value of the subject property.

The underwriting standards for loans purchased from correspondent and nationwide lenders are generally similar to the Bank's internal underwriting standards. The underwriting of correspondent loans is performed by the Bank's underwriters. Our standard contractual agreement with the lender/seller includes recourse options for any breach of representation or warranty with respect to the loans purchased. The Bank did not request any lenders/sellers to repurchase loans for breach of representation during fiscal year 2016.

### Adjustable-rate Mortgage ("ARM") Loans

ARM loans are offered with a three-year, five-year, or seven-year term to the initial repricing date. After the initial period, the interest rate for each ARM loan adjusts annually for the remainder of the term of the loan. Currently, the repricing index for loan originations and correspondent purchases is tied to London Interbank Offered Rates ("LIBOR"); however, other indices have been used in the past. Current adjustable-rate one- to four-family loans originated by the Bank generally provide for a specified rate limit or cap on the periodic adjustment to the interest rate, as well as a specified maximum lifetime cap and minimum rate, or floor. As a consequence of using caps, the interest rates on these loans may not be as rate sensitive as our cost of funds. Negative amortization of principal is not allowed. For three- and five-year ARM loans, borrowers are qualified based on the principal, interest, tax, and insurance payments at the initial interest rate plus the life of loan cap and the initial interest rate plus the first period cap, respectively. For seven-year ARM loans, borrowers are qualified based on the principal, interest, tax, and

insurance payments at the initial rate. After the initial three-, five-, or seven-year period, the interest rate resets annually and the new principal and interest payment is based on the new interest rate, remaining unpaid principal balance, and term of the ARM loan. Our ARM loans are not automatically convertible into fixed-rate loans; however, we do allow borrowers to pay an endorsement fee to convert an ARM loan to a fixed-rate loan. ARM loans can pose greater credit risks than fixed-rate loans, primarily because as interest rates rise, the borrower's payment also rises, increasing the potential for default. This specific type of risk is known as repricing risk.

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### Pricing

Our pricing strategy for one- to four-family loan products includes setting interest rates based on secondary market prices and local competitor pricing for our local lending markets, and secondary market prices and national competitor pricing for our correspondent markets.

### Mortgage Insurance

For a mortgage with a loan-to-value ("LTV") ratio in excess of 80% at the time of origination, private mortgage insurance ("PMI") is required in order to reduce the Bank's loss exposure. The Bank will lend up to 97% of the lesser of the appraised value or purchase price for one- to four-family loans, provided PMI is obtained. Management continuously monitors the claim-paying ability of our PMI counterparties. We believe our PMI counterparties have the ability to meet potential claim obligations we may file in the foreseeable future.

### Repayment

The Bank's one- to four-family loans are primarily fully amortizing fixed-rate or ARM loans. The contractual maturities for fixed-rate loans and ARM loans can be up to 30 years; however, there are certain bulk purchased ARM loans that had original contractual maturities of 40 years. Our one- to four-family loans are generally not assumable and do not contain prepayment penalties. A "due on sale" clause, allowing the Bank to declare the unpaid principal balance due and payable upon the sale of the secured property, is generally included in the security instrument.

### Construction Lending

The Bank originates and purchases, from correspondent lenders, construction-to-permanent loans secured by one- to four-family residential real estate. At September 30, 2016, we had \$39.4 million in construction-to-permanent one- to four-family loans outstanding representing approximately 1% of our total loan portfolio.

The majority of the one- to four-family construction loans are secured by property located within the Bank's Kansas City market area. Construction loans are obtained by homeowners who will occupy the property when construction is complete. Construction loans to builders for speculative purposes are not permitted. The application process includes submission of complete plans, specifications, and costs of the project to be constructed. All construction loans are manually underwritten using the Bank's internal underwriting standards. The Bank's one- to four-family construction-to-permanent loan program combines the construction loan and the permanent loan into one loan allowing the borrower to secure the same interest rate throughout the construction period and the permanent loan.

Construction draw requests and the supporting documentation are reviewed and approved by authorized management or experienced construction loan personnel. The Bank also performs regular documented inspections of the construction project to ensure the funds are being used for the intended purpose and the project is being completed according to the plans and specifications provided. The Bank charges a 1% fee at closing, based on the loan amount, for these administrative requirements. Interest is not capitalized during the construction period; it is billed and collected monthly based on the amount of funds disbursed. Once the construction period is complete, the payment method is changed from interest-only to an amortized principal and interest payment for the remaining term of the loan.

### Loan Endorsement Program

In an effort to offset the impact of repayments and to retain our customers, existing loan customers, including customers whose loans were purchased from a correspondent lender, have the opportunity, for a cash fee, to endorse their original loan terms to current loan terms being offered. Customers whose loans have been sold to third parties, or have been delinquent on their contractual loan payments during the previous 12 months, or are currently in bankruptcy, are not eligible to participate in this program. The Bank does not solicit customers for this program, but considers it a valuable opportunity to retain customers who, based on our initial underwriting criteria, could likely obtain similar financing elsewhere. During fiscal years 2016 and 2015, the Bank endorsed \$160.0 million and \$121.6

million of one- to four-family loans, respectively.

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### Loan Sales

One- to four-family loans may be sold on a bulk basis for portfolio restructuring or on a flow basis as loans are originated to reduce interest rate risk and/or maintain a certain liquidity position. Loans originated by the Bank and purchased from correspondent lenders are generally eligible for sale in the secondary market. The Bank generally retains the servicing on these loans. ALCO determines the criteria upon which one- to four-family loans are to be classified as held-for-sale or held-for-investment. One- to four-family loans classified as held-for-sale are to be sold in accordance with policies set forth by ALCO. One- to four-family loans classified as held-for-investment are generally not sold unless a specific segment of the portfolio is identified for asset restructuring purposes. The Bank did not sell any one- to four-family loans during fiscal years 2016 or 2015.

**Consumer Lending.** The Bank offers a variety of secured consumer loans, including home equity loans and lines of credit, home improvement loans, auto loans, and loans secured by savings deposits. The Bank also originates a very limited amount of unsecured loans. The Bank does not originate any consumer loans on an indirect basis, such as contracts purchased from retailers of goods or services which have extended credit to their customers. All consumer loans are originated in the Bank's market areas. At September 30, 2016, our consumer loan portfolio totaled \$127.6 million, or approximately 2% of our total loan portfolio.

The majority of our consumer loan portfolio is comprised of home equity lines of credit which have interest rates that can adjust monthly based upon changes in the Prime rate, up to a maximum of 18%. For a majority of the home equity lines of credit, the Bank has the first mortgage or the Bank is in the first lien position. Home equity lines of credit may be originated up to 90% of the value of the property securing the loan if no first mortgage exists, or up to 90% of the value of the property securing the loans if taking into consideration an existing first mortgage. Approximately 46%, or \$48.8 million, of our home equity lines at September 30, 2016 require a payment of 1.5% of the outstanding loan balance per month, but have no stated term-to-maturity and no repayment period. Repaid principal may be re-advanced at any time, not to exceed the original credit limit of the loan. Approximately 53%, or \$56.3 million, of our home equity lines at September 30, 2016 have a 7-year draw period, a 10-year repayment term, and typically a payment requirement of 1.5% of the outstanding loan balance per month during the draw period, with an amortizing payment during the repayment period. Repaid principal may be re-advanced at any time during the draw period, not to exceed the original credit limit of the loan. We also offer interest-only home equity lines of credit. These loans have a maximum term of 12 months and require monthly payments of accrued interest, and a balloon payment of unpaid principal at maturity. At September 30, 2016, approximately 1%, or \$1.0 million, of our home equity lines were interest-only. Closed-end home equity loans, which totaled \$17.2 million at September 30, 2016, may be originated up to 95% of the value of the property securing the loans if taking into consideration an existing first mortgage, or the lesser of up to \$40 thousand or 25% of the value of the property securing the loan if no first mortgage exists. The term-to-maturity for closed-end home equity loans in the first lien position may be up to 10 years, or may be up to 20 years for loans in the second lien position. Other consumer loan terms vary according to the type of collateral and the length of the contract. Home equity loans, including lines of credit and closed-end loans, comprised approximately 97% of our consumer loan portfolio, or \$123.3 million, at September 30, 2016; of that amount, 86% were adjustable-rate.

The underwriting standards for consumer loans include a determination of the applicant's payment history on other debts and an assessment of the applicant's ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is a primary consideration, the underwriting process also includes a comparison of the value of the security in relation to the proposed loan amount.

Consumer loans generally have shorter terms-to-maturity or reprice more frequently, usually without periodic caps, which reduces our exposure to credit risk and changes in interest rates, and usually carry higher rates of interest than do one- to four-family loans. However, consumer loans may entail greater credit risk than do one- to four-family loans, particularly in the case of consumer loans that are secured by rapidly depreciable assets, such as automobiles. Management believes that offering consumer loan products helps to expand and create stronger ties to our existing

customer base by increasing the number of customer relationships and providing cross-marketing opportunities.

Commercial Real Estate Lending. At September 30, 2016, the Bank's commercial real estate loans totaled \$154.1 million, or approximately 2% of our total loan portfolio. Of this amount, \$99.1 million were participation loans. Total undisbursed loan amounts related to commercial real estate loans were \$193.4 million, resulting in a total commercial real estate loan concentration of \$347.5 million at September 30, 2016.

During fiscal year 2016, the Bank entered into commercial real estate loan participations of \$201.1 million, of which \$34.9 million had been funded as of September 30, 2016. The Bank intends to continue to grow its commercial real estate loan portfolio through participations with correspondent lenders and other lead banks with which the Bank has commercial real estate lending relationships.

Our commercial real estate loans include a variety of property types, including hotels, office and retail buildings, senior housing facilities, and multi-family dwellings located in Texas, Missouri, Kansas, Colorado, Arkansas, California, and Montana. Our largest commercial real estate loan was \$50.0 million at September 30, 2016, but no funds had been disbursed on this loan at September 30, 2016. The commercial real estate loan with the largest unpaid principal balance at September 30, 2016 was a loan for \$24.5 million.

#### Underwriting

The Bank performs more extensive due diligence in underwriting commercial real estate loans than loans secured by one- to four-family residential properties due to the larger loan amounts, the more complex sources of repayment and the riskier nature of such loans. When participating in a commercial real estate loan, the Bank performs the same underwriting procedures as if the loan was being originated by the Bank. The primary source of repayment is funds from the operation of the subject property. For secondary sources of repayment, the Bank generally requires personal guarantees and also evaluates the real estate collateral.

When underwriting a commercial real estate loan, several factors are considered, such as the income producing potential of the property to support the debt service, cash equity provided by the borrower, the financial strength of the borrower, tenant and/or guarantor(s), managerial expertise of the borrower or tenant, feasibility studies from the borrower or an independent third party, the marketability of the property and our lending experience with the borrower. For non-owner occupied properties, the Bank has a pre-lease requirement, depending on the property type, and overall strength of the credit. Loans over \$750 thousand must be approved by our ALCO while loans over \$1.5 million must be approved by our Board of Directors.

For non-construction properties, the historical net operating income, which is the income derived from the operation of the property less all operating expenses, generally must be at least 1.25 times the required payments related to the outstanding debt (debt service coverage ratio) at the time of origination. For construction projects, the minimum debt service coverage ratio requirement of 1.25 applies to the projected cash flows, and the borrower must have successful experience with the construction and operation of properties similar to the subject property. As part of the underwriting process, the historical or projected cash flows are stressed under various scenarios to measure the viability of the project given adverse conditions.

Generally, our maximum LTV ratios conform to supervisory limits, including 65% for raw land, 75% for land development and 80% for commercial real estate loans. Full appraisals on properties securing these loans are performed by independent state certified fee appraisers. Additionally, the Bank has an independent third-party perform a review of each appraisal. The Bank generally requires at least 15% cash equity from the borrower for land acquisition, land development, and commercial real estate construction loans. For non-acquisition, development or construction loans, the equity may be from a combination of cash and the appraised value of the secured property.

#### Loan Terms

Commercial real estate loans generally have amortization terms of 15 to 30 years and maturities ranging from three to 20 years, which generally requires balloon payments of the remaining principal balance. The Bank has participated in a limited number of short-term loans with a maturity of three years or less. These loans are generally construction-only loans or land development loans that require interest-only payments for the entire term of the loan.

Commercial real estate loans have either fixed or adjustable interest rates based on prevailing market rates. The interest rate on ARM loans is based on a variety of indices, but is generally determined through negotiation with the



borrower or determined by the lead bank in the case of a loan participation. The Bank generally allows interest-only payments during the construction phase of a project before requiring amortizing payments once the loan converts to a permanent loan. For permanent loans, the Bank generally requires amortizing payments.

Additionally, the Bank may include covenants in the loan agreement that allow the Bank to take action when deterioration in the financial strength of the project is detected to potentially prevent the credit from becoming impaired. The covenants are specific to each loan agreement, based on factors such as the purpose of funds, the collateral type, and the financial strength of the project, the borrower and the guarantor, among other factors.

#### Monitoring of Risk

In order to monitor the adequacy of cash flows on income-producing properties with a principal balance of \$1.5 million or more, the borrower is required to provide financial information annually, including borrower financial statements, subject property rental rates and income, maintenance costs, an update of real estate property tax and insurance payments, and personal financial information for the guarantor(s). The annual review process for loans with a principal balance of \$1.5 million or more allows the Bank to monitor compliance with loan covenants and review the borrower's performance, including cash flows from operations, debt service coverage, and comparison of performance to projections and year-over-year performance trending. Additionally, the Bank performs a site visit, schedules a drive-by site visit or obtains an update from the lead bank to obtain information regarding the maintenance of the property and surrounding area. Depending on the financial strength of the project and/or the complexity of the borrower's financials, the Bank may also perform a global analysis of cash flows to account for all other properties owned by the borrower or guarantor. If signs of weakness are identified, the Bank may begin performing more frequent financial and/or collateral reviews or will initiate contact with the borrower, or the lead bank will contact the borrower if the loan is a participation loan, to ensure cash flows from operations are maintained at a satisfactory level to meet the debt requirements. Both macro-level and loan-level stress-test scenarios based on existing and forecasted market conditions are part of the on-going portfolio management process for the commercial real estate portfolio.

Commercial real estate construction lending generally involves a greater degree of risk than commercial real estate lending. Repayment of a construction loan is, to a great degree, dependent upon the successful and timely completion of the construction of the subject property. Construction delays, slower than anticipated stabilization or the financial impairment of the builder may negatively affect the borrower's ability to repay the loan. The Bank takes these risks into consideration during the underwriting process including the requirement of personal guarantees. The Bank mitigates the risk of commercial real estate construction lending during the construction period by monitoring inspection reports from an independent third-party, project budget, percentage of completion, on-site inspections and percentage of advanced funds.

Our commercial real estate loans are generally large dollar loans and involve a greater degree of credit risk than one-to four-family loans. Because payments on these loans are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the economy or the real estate market. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may become impaired. The Bank regularly monitors the level of risk in the portfolio, including concentrations in such factors as geographic locations, property types, tenant brand name, borrowing relationships, and lending relationships in the case of participation loans, among other factors.

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Loan Portfolio. The following table presents the composition of our loan portfolio as of the dates indicated.  
September 30,

2016	2015	2014	2013	2012		
<del>Amount</del> Amount	Percent	Amount	Percent	Amount	Percent	Amount