First Financial Northwest, Inc.
Form 10-Q
November 07, 2014

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

FORM 10-Q

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from ____________ to ____________

Commission File Number: 001-33652

FIRST FINANCIAL NORTHWEST, INC.
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	26-0610707 (I.R.S. Employer Identification Number)
201 Wells Avenue South, Renton, Washington (Address of principal executive offices)	98057 (Zip Code)
Registrant’s telephone number, including area code:	(425) 255-4400

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

YES X NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 X NO

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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer Accelerated filer X Non-accelerated filer 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 X

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 3, 2014, 15,379,198 shares of the issuer's common stock, $0.01 par value per share, were outstanding.

FIRST FINANCIAL NORTHWEST, INC.
FORM 10-Q
TABLE OF CONTENTS

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(Dollars in thousands, except share data)

Part 1. Financial Information

Item 1. Financial Statements

Assets	September 30, 2014 (Unaudited)	December 31, 2013
Cash on hand and in banks	$5,239	$6,074
Interest-earning deposits	50,388	49,501
Investments available-for-sale, at fair value	124,457	144,364
Loans receivable, net of allowance of $11,660 and $12,994, respectively	684,166	663,153
Federal Home Loan Bank ("FHLB") stock, at cost	6,815	7,017
Accrued interest receivable	3,401	3,698
Deferred tax assets, net	10,060	14,835
Other real estate owned ("OREO")	9,819	11,465
Premises and equipment, net	16,859	17,291
Prepaid expenses and other assets	4,215	3,581
Total assets	$915,419	$920,979
Liabilities and Stockholders' Equity		
Interest-bearing deposits	$575,687	$601,446
Noninterest-bearing deposits	14,678	10,619
Advances from the FHLB	135,500	119,000
Advance payments from borrowers for taxes and insurance	2,947	1,846
Accrued interest payable	130	88
Other liabilities	4,649	3,625
Total liabilities	733,591	736,624
Commitments and contingencies		
Stockholders' Equity		
Preferred stock, $0.01 par value; authorized 10,000,000 shares; no shares issued or outstanding	—	—
Common stock, $0.01 par value; authorized 90,000,000 shares; issued and outstanding 15,466,098 at September 30, 2014, and 16,392,139 shares at December 31, 2013	155	164
Additional paid-in capital	156,710	166,866
Retained earnings, substantially restricted	34,739	29,220
Accumulated other comprehensive loss, net of tax	(748)	(2,020)
Unearned Employee Stock Ownership Plan ("ESOP") shares	(9,028)	(9,875)
Total stockholders' equity	181,828	184,355
Total liabilities and stockholders' equity	$915,419	$920,979

See accompanying selected notes to consolidated financial statements.

3

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Income Statements
(Dollars in thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest income				
Loans, including fees	$9,157	$8,995	$27,270	$27,102
Investments available-for-sale	554	533	1,743	1,609
Interest-earning deposits	23	19	65	58
Dividends on FHLB stock	2	2	5	2
Total interest income	$9,736	$9,549	$29,083	$28,771
Interest expense				
Deposits	1,193	1,655	3,778	5,311
FHLB advances	324	149	854	521
Total interest expense	$1,517	$1,804	$4,632	$5,832
Net interest income	8,219	7,745	24,451	22,939
(Recapture of provision) provision for loan losses	(300)	—	(900)	100
Net interest income after (recapture of provision) provision for loan losses	$8,519	$7,745	$25,351	$22,839
Noninterest income				
Net loss on sale of investments	—	(39)	(20)	(38)
Other	186	159	362	417
Total noninterest income	$186	$120	$342	$379
Noninterest expense				
Salaries and employee benefits	2,947	3,807	8,693	11,147
Occupancy and equipment	324	339	1,002	1,038
Professional fees	457	452	1,208	1,195
Data processing	153	175	485	513
Loss (gain) on sale of OREO property, net	(15)	(35)	92	(1,050)
OREO market value adjustments	60	135	348	356
OREO related expenses, net	49	23	188	508
Regulatory assessments	102	172	284	549
Insurance and bond premiums	100	124	305	388
Marketing	15	29	77	89
Prepayment penalty on FHLB advances	—	—	—	679
Other general and administrative	316	167	1,052	1,160
Total noninterest expense	$4,508	$5,388	$13,734	$16,572
Income before federal income tax provision (benefit)	4,197	2,477	11,959	6,646
Federal income tax provision (benefit)	1,462	(135)	4,212	(13,886)
Net income	$2,735	$2,612	$7,747	$20,532
Basic earnings per share	$0.19	$0.16	$0.52	$1.21
Diluted earnings per share	$0.19	$0.16	$0.51	$1.21

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$2,735	$2,612	$7,747	$20,532
Other comprehensive income (loss), before tax:				
Unrealized holding gains (losses) on investments available-for-sale (net of tax (benefit) provision of ($89) and $136 for the third quarter of 2014, and 2013, respectively, and net of tax provision of $678 and $136 for the first nine months of 2014, and 2013, respectively.)	(166)	254	1,259	(2,342)
Reclassification adjustment for net losses realized in income (net of tax benefit of $0 and $14 for the third quarter of 2014 and 2013, respectively, and $7 and $14 for the first nine months of 2014 an 2013, respectively.)	—	25	13	24
Other comprehensive income (loss), net of tax	$(166)	$279	$1,272	$(2,318)
Total comprehensive income	$2,569	$2,891	$9,019	$18,214

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the Nine Months Ended September 30, 2014, and 2013
(Dollars in thousands)
(Unaudited)

	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2013	16,392,139	$164	$166,866	$29,220	$ (2,020)	$(9,875)	$ 184,355
Other comprehensive income	—	—	—	7,747	1,272	—	9,019
Cash dividend declared and paid ($0.15 per share)	—	—	—	(2,228)	—	—	(2,228)
Exercise of stock options	340,880	4	3,331	—	—	—	3,335
Repurchase and retirement of common stock	(1,266,921)	(13)	(13,812)	—	—	—	(13,825)
Compensation related to stock options and restricted stock awards	—	—	275	—	—	—	275
Allocation of 84,640 ESOP shares	—	—	50	—	—	847	897
Balances at September 30, 2014	15,466,098	$155	$156,710	$34,739	$ (748)	$(9,028)	$ 181,828

	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2012	18,805,168	$188	$190,534	$6,650	$748	$(11,003)	$187,117
Other comprehensive income	—	—	—	20,532	(2,318)	—	18,214
Cash dividend declared and paid ($0.08 per share)	—	—	—	(1,290)	—	—	(1,290)
Exercise of stock options	140,989	1	1,320	—	—	—	1,321
Purchase and retirement of common stock	(2,156,367)	(21)	(21,847)	—	—	—	(21,868)
Compensation related to stock options and restricted stock awards	—	—	1,330	—	—	—	1,330
Allocation of 84,640 ESOP shares	—	—	(59)	—	—	846	787
Balances at September 30, 2013	16,789,790	$168	$171,278	$25,892	$(1,570)	$(10,157)	$185,611

See accompanying selected notes to consolidated financial statements.

6

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$7,747	$20,532
Adjustments to reconcile net income to net cash provided by operating activities:		
(Recapture of provision) provision for loan losses	(900)	100
OREO market value adjustments	348	356
Loss (gain) on sale of OREO property, net	92	(1,050)
Loss on sale of investments	20	38
Loss on sale of premises and equipment	11	—
Depreciation of premises and equipment	568	606
Net amortization of premiums and discounts on investments	1,086	1,460
Deferred federal income taxes (benefit)	4,089	(13,992)
Allocation of ESOP shares	897	787
Stock compensation expense	275	1,330
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	(634)	528
Net increase in advance payments from borrowers for taxes and insurance	1,101	803
Accrued interest receivable	297	(166)
Accrued interest payable	42	(117)
Other liabilities	1,024	370
Net cash provided by operating activities	$16,063	$11,585
Cash flows from investing activities:		
Capital expenditures related to OREO	(120)	(33)
Proceeds from sales of OREO properties	3,149	11,890
Proceeds from sales and call of investments	6,380	40,155
Principal repayments on investments	15,942	21,189
Purchases of investments	(1,563)	(63,949)
Net increase in loans receivable	(21,936)	(8,641)
FHLB stock redemption	202	198
Purchases of premises and equipment	(147)	(24)
Net cash provided by investing activities	$1,907	$785
Cash flows from financing activities:		
Net decrease in deposits	(21,700)	(46,604)
Advances from the FHLB	16,500	74,010
Repayments of advances from the FHLB	—	(83,076)
Proceeds from stock options exercises	3,335	1,321
Repurchase and retirement of common stock	(13,825)	(21,868)
Dividends paid	(2,228)	(1,290)
Net cash used by financing activities	$(17,918)	$(77,507)

Continued

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2014	2013
Net increase (decrease) in cash and cash equivalents	$52	$(65,137)
Cash and cash equivalents at beginning of period	55,575	87,741
Cash and cash equivalents at end of period	$55,627	$22,604
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest paid	$4,590	$5,949
Federal income taxes paid	284	31
Noncash items:		
Loans transferred to OREO, net of deferred loan fees and allowance for loan losses	$1,823	$6,416
Change in unrealized loss on investments available for sale	1,958	2,168
Investment transactions payable	—	5,125
Investment transactions receivable	—	4,982

See accompanying selected notes to consolidated financial statements.

8

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 - Description of Business

First Financial Northwest, Inc. (“First Financial Northwest”), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest (“First Savings Bank” or “the Bank”) in connection with the conversion from a mutual holding company structure to a stock holding company structure completed on October 9, 2007. First Financial Northwest's business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information presented in the consolidated financial statements and accompanying data, relates primarily to First Savings Bank. First Financial Northwest is a savings and loan holding company and is subject to regulation by the Federal Reserve Bank of San Francisco (“FRB”). First Savings Bank is regulated by the Federal Deposit Insurance Corporation (“FDIC”) and the Washington State Department of Financial Institutions (“DFI”).

First Savings Bank is a community-based savings bank primarily serving King, and to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington, through one full-service banking office located in Renton, Washington. First Savings Bank's business consists of attracting deposits from the public and utilizing these deposits to originate one-to-four family residential, multifamily, commercial real estate, business, consumer, and construction/land development loans. The Bank's current business strategy emphasizes commercial real estate, construction, one-to-four family residential, and multifamily lending.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to First Financial Northwest, Inc. and its consolidated subsidiary First Savings Bank Northwest, unless the context otherwise requires.

Note 2 - Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles (“GAAP”) for complete financial statements. These unaudited consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the nine months ended September 30, 2014, are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the allowance for loan and lease losses ("ALLL"), the valuation of OREO and the underlying collateral of loans in the process of foreclosure, deferred tax assets, and the fair value of financial instruments.

The Company's activities are considered to be a single industry segment for financial reporting purposes. The Company is engaged in the business of attracting deposits from the general public and originating loans for our portfolio in our primary market area. Substantially all income is derived from a diverse base of commercial and residential real estate loans, consumer lending activities, and investments.

Certain amounts in the unaudited consolidated financial statements for prior periods have been reclassified to conform to the current unaudited financial statement presentation with no effect on consolidated net income or stockholders' equity.

Note 3 - Recently Issued Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-14, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure. ASU 2014-14 addresses certain government-sponsored loan guarantee programs, such as those offered by the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA), where qualifying creditors can extend mortgage loans to borrowers with a guarantee that entitles the creditor to recover all or a portion of the unpaid principal balance from the government if the borrower defaults. The objective of this ASU is to reduce variations in practice by addressing the classification of foreclosed mortgage loans that are fully or partially guaranteed under government programs.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Currently, some creditors reclassify those loans to real estate as with other foreclosed loans that do not have guarantees; others reclassify the loans to other receivables. The amendments affect creditors that hold government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA. The ASU is effective for annual and interim periods beginning after December 15, 2014. The adoption of this ASU will not have a material impact on the Company's consolidated financial statements.
In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. ASU 2014-15 defines management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. Under GAAP, financial statements are prepared under the presumption that the reporting organization will continue to operate as a going concern, except in limited circumstances. The going concern basis of accounting is critical to financial reporting because it establishes the fundamental basis for measuring and classifying assets and liabilities. Currently, GAAP lacks guidance about management's responsibility to evaluate whether there is substantial doubt about the organization's ability to continue as a going concern or to provide related footnote disclosures. The ASU is effective for annual and interim periods beginning after December 15, 2016, and should be applied prospectively. The adoption of this ASU will not have a material impact on the Company's consolidated financial statements.

Note 4 - Investments

Investments available-for-sale are summarized as follows at the dates indicated:

	September 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$42,032	$754	$(164)	$42,622
Freddie Mac	22,593	481	(112)	22,962
Ginnie Mae	27,839	77	(216)	27,700
Municipal bonds	642	1	—	643
U.S. Government agencies	16,652	105	(296)	16,461
Corporate bonds	14,066	65	(62)	14,069
Total	$123,824	$1,483	$(850)	$124,457

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$46,234	$623	$(625)	$46,232
Freddie Mac	25,707	343	(194)	25,856
Ginnie Mae	34,403	63	(593)	33,873
Municipal bonds	2,043	6	(199)	1,850
U.S. Government agencies	23,222	123	(641)	22,704
Corporate bonds	14,079	36	(266)	13,849
Total	$145,688	$1,194	$(2,518)	$144,364

The following table summarizes the aggregate fair value and gross unrealized loss by length of time those investments have been continuously in an unrealized loss position at the dates indicated:

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	September 30, 2014					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
Mortgage-backed investments:						
Fannie Mae	$17,781	$(164)	$—	$—	$17,781	$(164)
Freddie Mac	4,628	(112)	—	—	4,628	(112)
Ginnie Mae	11,301	(139)	6,982	(77)	18,283	(216)
U.S. Government agencies	8,179	(296)	—	—	8,179	(296)
Corporate bonds	5,943	(58)	1,496	(4)	7,439	(62)
Total	$47,832	$(769)	$8,478	$(81)	$56,310	$(850)

	December 31, 2013					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
Mortgage-backed investments:						
Fannie Mae	$27,429	$(625)	$—	$—	$27,429	$(625)
Freddie Mac	8,704	(155)	2,483	(39)	11,187	(194)
Ginnie Mae	16,617	(278)	12,730	(315)	29,347	(593)
Municipal bonds	—	—	1,201	(199)	1,201	(199)
U.S. Government agencies	7,702	(596)	4,955	(45)	12,657	(641)
Corporate bonds	8,796	(266)	—	—	8,796	(266)
Total	$69,248	$(1,920)	$21,369	$(598)	$90,617	$(2,518)

At September 30, 2014, the Company had 34 securities with a gross unrealized loss of $850,000 and a fair value of $56.3 million. At December 31, 2013, there were 44 securities that had a gross unrealized loss of $2.5 million with a fair value of $90.6 million.

On a quarterly basis, management makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security on which there is an unrealized loss is impaired on an other-than-temporary basis. The Company considers many factors including the severity and duration of the impairment, recent events specific to the issuer or industry, and for debt securities, external credit ratings and recent downgrades. Securities on which there is an unrealized loss that is deemed to be an other-than-temporary impairment ("OTTI") are written down to fair value. For equity securities, the write-down is recorded as a realized loss in noninterest income on the Company's Consolidated Income Statements. For debt securities, if the Company intends to sell the security or it is likely that the Company will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the Company does not intend to sell the security and it is not likely that it will be required to sell the security but does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (“OCI”). Impairment losses related to all other factors are presented as separate categories within OCI. Management reviewed the financial condition of the entities issuing municipal or corporate bonds at September 30, 2014, and December 31, 2013, and determined that an OTTI charge was not warranted.

The amortized cost and estimated fair value of investments available-for-sale at September 30, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments, are shown separately.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	September 30, 2014	
	Amortized Cost	Fair Value
	(In thousands)	
Due within one year	$—	$—
Due after one year through five years	10,809	10,815
Due after five years through ten years	14,999	14,878
Due after ten years	5,552	5,480
	31,360	31,173
Mortgage-backed investments	92,464	93,284
Total	$123,824	$124,457

Under Washington state law, in order to participate in the public funds program the Company is required to pledge as collateral an amount equal to 100% of the public deposits held in the form of eligible securities. Investments with a market value of $16.6 million and $21.3 million were pledged as collateral for public deposits at September 30, 2014 and December 31, 2013, respectively, both of which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission.

For the three months ended September 30, 2014, we did not sell any of our investments. For the three months ended September 30, 2013, we sold $15.1 million of investments generating a gross loss of $39,000. During the nine months ended September 30, 2014, we sold $5.0 million of investments generating a gross loss of $20,000. For the nine months ended September 30, 2013, we sold $45.1 million of investments resulting in a gross gain of $10,000 and a gross loss of $48,000.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 5 - Loans Receivable

Loans receivable are summarized as follows at the dates indicated:

	September 30, 2014	December 31, 2013
	(In thousands)	
One-to-four family residential:		
Permanent owner occupied	$163,941	$158,797
Permanent non-owner occupied	115,047	121,877
Construction non-owner occupied	500	—
	279,488	280,674
Multifamily:		
Permanent	119,401	106,152
Construction	4,200	12,360
	123,601	118,512
Commercial real estate:		
Permanent	251,068	227,016
Construction	6,100	19,905
Land	3,869	1,831
	261,037	248,752
Construction/land development: (1)		
One-to-four family residential	19,222	3,977
Multifamily	15,845	12,491
Commercial	5,182	6,726
Land development	8,861	7,461
	49,110	30,655
Business	2,148	1,142
Consumer	7,543	9,201
Total loans	722,927	688,936
Less:		
Loans in process ("LIP")	24,343	10,209
Deferred loan fees, net	2,758	2,580
ALLL	11,660	12,994
Loans receivable, net	$684,166	$663,153

____

(1) Excludes construction loans that will convert to permanent loans. The Company considers these loans to be "rollovers" in that one loan is originated for both the construction loan and permanent financing. These loans are classified according to the underlying collateral. At September 30, 2014, the Company had $6.1 million, or 2.3% of the total commercial real estate portfolio, $4.2 million, or 3.4% of its total multifamily portfolio, and $500,000 or 0.2% of the total one-to-four family residential portfolio in these rollover types of loans. At December 31, 2013, the Company had $19.9 million, or 8.0% of the total commercial real estate portfolio and $12.4 million, or 10.4% of the total multifamily portfolio in these rollover types of loans. At September 30, 2014, and December 31, 2013, $3.9 million and $1.8 million, respectively, of commercial real estate loans were not included in the construction/land development category because the Company classifies raw land or buildable lots (where we do not intend to finance

the construction) as commercial real estate land loans.

At both September 30, 2014, and December 31, 2013, there were no loans classified as held for sale.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

ALLL. The Company maintains an ALLL as a reserve against probable and inherent risk of losses in its loan portfolios. The ALLL is comprised of a general reserve component for loans evaluated collectively for loss and a specific reserve component for loans evaluated individually. We continually monitor our loan portfolio for delinquent loans and changes in our borrower's financial condition. When an issue is identified and it is determined that the loan needs to be classified as nonperforming and/or impaired, an evaluation of the collateral is performed and, if necessary, an appraisal is ordered in accordance with our appraisal policy guidelines. Based on this evaluation, any additional provision for loan loss or charge-offs that may be needed is recorded prior to the end of the financial reporting period.

The following tables summarize changes in the ALLL and loan portfolio by loan type and impairment method for the periods shown:

	At or For the Three Months Ended September 30, 2014						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
	(In thousands)						
ALLL:							
Beginning balance	$4,377	$1,433	$5,622	$333	$11	$175	$11,951
Charge-offs	(3)	—	—	—	—	(6)	(9)
Recoveries	12	—	—	—	5	1	18
Provision (recapture)	(379)	(64)	97	49	10	(13)	(300)
Ending balance	$4,007	$1,369	$5,719	$382	$26	$157	$11,660

	At or For the Nine Months Ended September 30, 2014						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
	(In thousands)						
ALLL:							
Beginning balance	$5,141	$1,377	$5,881	$399	$14	$182	$12,994
Charge-offs	(78)	—	(311)	(223)	—	(30)	(642)
Recoveries	46	—	151	—	6	5	208
Provision (recapture)	(1,102)	(8)	(2)	206	6	—	(900)
Ending balance	$4,007	$1,369	$5,719	$382	$26	$157	$11,660
Allowance by category:							
General reserve	$2,896	$1,340	$5,240	$382	$26	$157	$10,041
Specific reserve	1,111	29	479	—	—	—	1,619
Loans: (1)							
Total loans	$279,360	$123,599	$260,198	$25,736	$2,148	$7,543	$698,584
General reserves (2)	234,094	121,417	250,392	25,736	2,148	7,423	641,210
Specific reserves (3)	45,266	2,182	9,806	—	—	120	57,374

---

(1) Net of LIP.
(2) Loans collectively evaluated for general reserves.

(3) Loans individually evaluated for specific reserves.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	At or For the Three Months Ended September 30, 2013						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
	(In thousands)						
ALLL:							
Beginning balance	$4,970	$1,300	$5,519	$345	$21	$158	$12,313
Charge-offs	(107)	—	—	—	—	—	(107)
Recoveries	—	29	2	27	—	7	65
Provision (recapture)	(4)	44	(3)	(27)	1	(11)	—
Ending balance	$4,859	$1,373	$5,518	$345	$22	$154	$12,271

	At or For the Nine Months Ended September 30, 2013						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
	(In thousands)						
ALLL:							
Beginning balance	$5,562	$1,139	$5,207	$437	$30	$167	$12,542
Charge-offs	(416)	(346)	(98)	(332)	—	(71)	(1,263)
Recoveries	533	237	5	97	—	20	892
Provision (recapture)	(820)	343	404	143	(8)	38	100
Ending balance	$4,859	$1,373	$5,518	$345	$22	$154	$12,271
Allowance by category:							
General reserve	$3,590	$1,285	$5,230	$345	$22	$154	$10,626
Specific reserve	1,269	88	288	—	—	—	1,645
Loans: (1)							
Total loans	$279,336	$116,801	$240,059	$19,785	$1,795	$9,535	$667,311
General reserves (2)	227,821	114,345	226,697	15,457	1,795	8,873	594,988
Specific reserves (3)	51,515	2,456	13,362	4,328	—	662	72,323

(1) Net of LIP.
(2) Loans collectively evaluated for general reserves.
(3) Loans individually evaluated for specific reserves.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. At September 30, 2014, total past due loans comprised 0.38% of total loans as compared to 0.63% at December 31, 2013. The following tables represent a summary of the aging of loans by type at the dates indicated:

	Loans Past Due as of September 30, 2014					
	30-59 Days	60-89 Days	90 Days and Greater	Total Past Due	Current	Total [(1) (2)]
	(In thousands)					
Real estate:						
One-to-four family residential:						
Owner occupied	$1,351	$—	$435	$1,786	$162,155	$163,941
Non-owner occupied	271	—	165	436	114,983	115,419
Multifamily	—	—	—	—	123,599	123,599
Commercial real estate	326	—	—	326	259,872	260,198
Construction/land development	—	—	—	—	25,736	25,736
Total real estate	1,948	—	600	2,548	686,345	688,893
Business	—	—	—	—	2,148	2,148
Consumer	—	—	77	77	7,466	7,543
Total loans	$1,948	$—	$677	$2,625	$695,959	$698,584

(1) There were no loans 90 days and greater past due and still accruing interest at September 30, 2014.
(2) Net of LIP.

	Loans Past Due as of December 31, 2013					
	30-59 Days	60-89 Days	90 Days and Greater	Total Past Due	Current	Total [(1) (2)]
	(In thousands)					
Real estate:						
One-to-four family residential:						
Owner occupied	$923	$337	$575	$1,835	$156,962	$158,797
Non-owner occupied	—	—	692	692	121,185	121,877
Multifamily	—	—	—	—	117,181	117,181
Commercial real estate	331	—	1,089	1,420	245,982	247,402
Construction/land development	—	—	223	223	22,904	23,127
Total real estate	1,254	337	2,579	4,170	664,214	668,384
Business	—	—	—	—	1,142	1,142
Consumer	103	34	—	137	9,064	9,201
Total loans	$1,357	$371	$2,579	$4,307	$674,420	$678,727

(1) There were no loans 90 days and greater past due and still accruing interest at December 31, 2013.
(2) Net of LIP.

Nonaccrual Loans. Loans are placed on nonaccrual when they are 90 days delinquent or when, in management's opinion, the borrower is unable to meet scheduled payment obligations.

In order to return a nonaccrual loan to accrual status, the Company evaluates the borrower's financial condition to ensure that future loan payments are reasonably assured. The Company also takes into consideration the borrower's willingness and ability to make the loan payments, as well as historical repayment performance. The Company requires the borrower to make loan payments

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

consistently for a period of at least six months as agreed to under the terms of the loan agreement before the Company will consider reclassifying the loan to accrual status.

The following table is a summary of nonaccrual loans by loan type at the dates indicated:

	September 30, 2014	December 31, 2013
	(In thousands)	
One-to-four family residential	$837	$2,297
Multifamily	—	233
Commercial real estate	658	1,198
Construction/land development	—	223
Consumer	77	44
Total nonaccrual loans	$1,572	$3,995

Nonaccrual loans were $1.6 million and $4.0 million at September 30, 2014, and December 31, 2013, respectively. Foregone interest on nonperforming loans for the three months ended September 30, 2014, was $26,000, compared to $167,000 for the same quarter in 2013. Foregone interest for the nine months ended September 30, 2014, was $105,000 compared to $684,000 for the nine months ended September 30, 2013.

The following tables summarize the loan portfolio by type and payment status at the dates indicated:

	September 30, 2014						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction / Land Development	Business	Consumer	Total [1]
	(In thousands)						
Performing [2]	$278,523	$123,599	$259,540	$25,736	$2,148	$7,466	$697,012
Nonperforming [3]	837	—	658	—	—	77	1,572
Total loans	$279,360	$123,599	$260,198	$25,736	$2,148	$7,543	$698,584

(1) Net of LIP.
(2) There were $163.3 million of owner-occupied one-to-four family residential loans and $115.2 million of non-owner occupied one-to-four family residential loans classified as performing.
(3) There were $672,000 of owner-occupied one-to-four family residential loans and $165,000 of non-owner occupied one-to-four family residential loans classified as nonperforming.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	December 31, 2013						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total [1]
	(In thousands)						
Performing [2]	$278,377	$116,948	$246,204	$22,904	$1,142	$9,157	$674,732
Nonperforming [3]	2,297	233	1,198	223	—	44	3,995
Total loans	$280,674	$117,181	$247,402	$23,127	$1,142	$9,201	$678,727

[1] Net of LIP.
[2] There were $157.3 million of owner-occupied one-to-four family residential loans and $121.1 million of non-owner occupied one-to-four family residential loans classified as performing.
[3] There were $1.5 million of owner-occupied one-to-four family residential loans and $817,000 of non-owner occupied one-to-four family residential loans classified as nonperforming.

Impaired Loans. A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the original loan document. When identifying loans as impaired, management takes into consideration factors which include payment history and status, collateral value, financial condition of the borrower, and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered by management on a case-by-case basis after taking into consideration the circumstances surrounding the loan and the borrower, including payment history and the amounts of any payment shortfall, length and reason for delay and the likelihood of a return to stable performance. Impairment is measured on a loan-by-loan basis for all loans in the portfolio. We obtain annual updated appraisals for impaired collateral dependent loans that exceed $1.0 million.

There were no funds committed to be advanced in connection with impaired loans at either September 30, 2014, or December 31, 2013.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following tables present a summary of loans individually evaluated for impairment by loan type at the dates indicated:

	September 30, 2014		
	Recorded Investment (1)	Unpaid Principal Balance (2)	Related Allowance
	(In thousands)		
Loans with no related allowance:			
One-to-four family residential:			
Owner occupied	$3,332	$3,681	$—
Non-owner occupied	28,797	28,842	—
Commercial real estate	2,785	3,128	—
Consumer	120	153	—
Total	35,034	35,804	—
Loans with an allowance:			
One-to-four family residential:			
Owner occupied	2,562	2,632	125
Non-owner occupied	10,575	10,627	986
Multifamily	2,182	2,182	29
Commercial real estate	7,021	7,021	479
Total	22,340	22,462	1,619
Total impaired loans:			
One-to-four family residential:			
Owner occupied	5,894	6,313	125
Non-owner occupied	39,372	39,469	986
Multifamily	2,182	2,182	29
Commercial real estate	9,806	10,149	479
Consumer	120	153	—
Total	$57,374	$58,266	$1,619

___

(1) Represents the loan balance less charge-offs.
(2) Contractual loan principal balance.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	December 31, 2013 Recorded Investment [1] (In thousands)	Unpaid Principal Balance [2]	Related Allowance
Loans with no related allowance:			
One-to-four family residential:			
Owner occupied	$3,878	$4,281	$—
Non-owner occupied	28,782	28,854	—
Multifamily	233	264	—
Commercial real estate	6,224	6,511	—
Construction/land development	223	4,812	—
Consumer	44	70	—
Total	39,384	44,792	—
Loans with an allowance:			
One-to-four family residential:			
Owner occupied	3,191	3,238	263
Non-owner occupied	12,297	12,352	1,277
Multifamily	2,208	2,208	85
Commercial real estate	7,085	7,085	555
Total	24,781	24,883	2,180
Total impaired loans:			
One-to-four family residential:			
Owner occupied	7,069	7,519	263
Non-owner occupied	41,079	41,206	1,277
Multifamily	2,441	2,472	85
Commercial real estate	13,309	13,596	555
Construction/land development	223	4,812	—
Consumer	44	70	—
Total	$64,165	$69,675	$2,180

(1) Represents the loan balance less charge-offs.
(2) Contractual loan principal balance.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following tables present the average recorded investment in loans individually evaluated for impairment and the interest income recognized for the three and nine months ended September 30, 2014, and 2013:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$3,256	$45	$3,444	$115
Non-owner occupied	28,984	438	28,995	1,312
Multifamily	111	—	171	—
Commercial real estate	2,812	41	4,388	123
Construction/land development	—	—	56	—
Consumer	82	2	63	3
Total	$35,245	$526	37,117	1,553
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	2,974	29	3,134	94
Non-owner occupied	10,792	147	11,307	447
Multifamily	2,187	36	2,196	107
Commercial real estate	7,032	101	7,054	282
Total	22,985	313	23,691	930
Total impaired loans:				
One-to-four family residential:				
Owner occupied	6,230	74	6,578	209
Non-owner occupied	39,776	585	40,302	1,759
Multifamily	2,298	36	2,367	107
Commercial real estate	9,844	142	11,442	405
Construction/land development	—	—	56	—
Consumer	82	2	63	3
Total	$58,230	$839	$60,808	$2,483

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$ 4,908	$ 30	$ 4,989	$ 88
Non-owner occupied	29,372	448	30,661	1,297
Multifamily	241	—	2,572	—
Commercial real estate	6,494	94	8,040	229
Construction/land development	4,348	—	4,553	—
Consumer	689	—	718	—
Total	46,052	572	51,533	1,614
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	4,295	41	4,926	153
Non-owner occupied	13,916	142	14,954	503
Multifamily	1,723	59	862	99
Commercial real estate	8,050	93	8,075	301
Total	27,984	335	28,817	1,056
Total impaired loans:				
One-to-four family residential:				
Owner occupied	9,203	71	9,915	241
Non-owner occupied	43,288	590	45,615	1,800
Multifamily	1,964	59	3,434	99
Commercial real estate	14,544	187	16,115	530
Construction/land development	4,348	—	4,553	—
Consumer	689	—	718	—
Total	$ 74,036	$ 907	$ 80,350	$ 2,670

Troubled Debt Restructurings. Certain loan modifications are accounted for as troubled debt restructured loans ("TDRs"). In general, the modification or restructuring of a debt is considered a TDR if, for economic or legal reasons related to the borrower's financial difficulties, a concession is granted to the borrower that the Company would not otherwise consider. Once the loan is restructured, a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment are performed to assess the likelihood that all principal and interest payments required under the terms of the modified agreement will be collected in full. A loan that is classified as a TDR is generally reported as a TDR until the loan is paid in full or otherwise settled, sold, or charged-off.

The accrual status of a loan may change after it has been classified as a TDR. Management considers the following in determining the accrual status of restructured loans: (1) if the loan was on accrual status prior to the restructuring, the borrower has demonstrated performance under the previous terms, and a credit evaluation shows the borrower's capacity to continue to perform under the restructured terms (both principal and interest payments), the loan will remain on accrual at the time of the restructuring; (2) if the loan was on nonaccrual status before the restructuring, and the Company's credit evaluation shows the borrower's capacity to meet the restructured terms, the loan would remain as nonaccrual for a minimum of six months after restructuring until the borrower has demonstrated a reasonable period of sustained repayment performance, thereby providing reasonable assurance as to the ultimate collection of principal and interest in full under the modified terms.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

At September 30, 2014, the TDR portfolio totaled $55.8 million, all of which were on accrual status and performing in accordance with the terms of their restructure. At December 31, 2013, the TDR balance was $61.1 million, of which $968,000 were on nonaccrual status. Of these nonaccrual loans, $379,000 were performing under their modified terms.

The following tables present loans that were modified as TDRs within the periods indicated, and their recorded investment both prior to and after the modification:

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(Dollars in thousands)					
One-to-four family residential:						
Interest-only payments with interest rate concession	6	$ 1,439	$ 1,439	6	$ 1,439	$ 1,439
Principal and interest with interest rate concession	5	953	953	6	1,174	1,174
Advancement of maturity date	—	—	—	4	772	772
Commercial real estate:						
Interest-only payments with interest rate concession	1	1,466	1,466	2	3,470	3,470
Total	12	$ 3,858	$ 3,858	18	$ 6,855	$ 6,855

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(Dollars in thousands)					
One-to-four family residential:						
Interest-only payments with no interest rate concession	—	$ —	$ —	2	$ 682	$ 682
Principal and interest with interest rate concession	—	—	—	2	1,620	1,556
Principal and interest reamortized with no interest rate concession	1	261	261	1	261	261

Advancement of maturity date	—	—	—	1	311	306
Commercial real estate:						
Principal and interest reamortized with no interest rate concession	—	—	—	1	335	332
Interest-only payments with interest rate concession	—	—	—	2	3,484	3,483
Advancement of maturity date	1	437	436	1	437	436
Total	2	$ 698	$ 697	10	$ 7,130	$ 7,056

23

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

At September 30, 2014, the Company had no commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the ALLL.

The TDRs that occurred during the three and nine months ended September 30, 2014, and 2013, were the result of advancing the maturity date for balloon payments on loans otherwise current on principal and interest payments, or granting the borrower interest rate concessions and/or interest-only payments for a period of time ranging from one to three years. The impaired portion of the loan with an interest rate concession and/or interest-only payments for a specific period of time are calculated based on the present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate is the rate of return implicit on the original loan. This impaired amount increases the ALLL and is expensed to earnings. As loan payments are received in future periods, the entry is amortized over the life of the concession, reducing ALLL and recapturing provision expense. TDRs resulted in no charge-offs to the ALLL for the three and nine months ended September 30, 2014, and $0 and $89,000 for the three and nine months ended September 30, 2013, respectively.

The following is a summary of loans that were modified as TDRs within the 12 months prior to September 30, 2014, or 2013, and for which there was a payment default during the three and nine months ended September 30, 2014, or 2013:

	Types of Modification							
	Three Months Ended September 30, 2014				Nine Months Ended September 30, 2014			
	Number of Loans	No Interest Rate Concession with Modified Payment	Interest Rate Concession	Advancement of Maturity Date	Number of Loans	No Interest Rate Concession with Modified Payment	Interest Rate Concession	Advancement of Maturity Date
	(Dollars in thousands)							
Commercial real estate	—	$—	$—	$—	1	$—	$—	$ 430
Total	—	$—	$—	$—	1	$—	$—	$ 430

	Types of Modifications							
	Three Months Ended September 30, 2013				Nine Months Ended September 30, 2013			
	Number of Loans	No Interest Rate Concession with Modified Payment	Interest Rate Concession	Advancement of Maturity Date	Number of Loans	No Interest Rate Concession with Modified Payment	Interest Rate Concession	Advancement of Maturity Date
	(Dollars in thousands)							
Commercial real estate	1	$—	$—	$ 436	3	$ 332	$ 935	$ 436
Total	1	$—	$—	$ 436	3	$ 332	$ 935	$ 436

TDRs that default after they have been modified are typically evaluated individually on a collateral basis. Any additional impairment further reduces the ALLL. For the three months ended September 30, 2014, no loans defaulted that had been modified within the previous 12 months. For the nine months ended September 30, 2014, one loan that was restructured during the previous 12 months missed a payment, but has since become current.

Credit Quality Indicators. The Company utilizes a nine-category risk rating system and assigns a risk rating for all credit exposures. The risk rating system is designed to define the basic characteristics and identify risk elements of each credit extension. Credits risk rated 1 through 5 are considered to be “pass” credits. Pass credits include assets, such as cash secured loans with funds on deposit with the Bank, where there is virtually no credit risk. Pass credits also include credits that are on the Company's watch list, where the borrower exhibits potential weaknesses, which may, if not checked or corrected, negatively affect the borrower’s financial capacity and threaten their ability to fulfill debt obligations in the future. Credits classified as special mention are risk rated 6 and possess weaknesses that deserve management’s close attention. Special mention assets do not expose the Company to

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

sufficient risk to warrant adverse classification in the substandard, doubtful or loss categories. Substandard credits are risk rated 7. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged.
Substandard assets include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful are risk rated 8 and have all the weaknesses inherent in those credits classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions, and values. Assets classified as loss are risk rated 9 and are considered uncollectible and cannot be justified as a viable asset for the Company. There were no loans classified as doubtful or loss at September 30, 2014, and December 31, 2013.

The following tables represent a summary of loans by type and risk category at the dates indicated:

	September 30, 2014						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total [1]
	(In thousands)						
Risk Rating:							
Pass	$267,410	$122,177	$246,679	$25,736	$2,148	$7,244	$671,394
Special mention	4,758	—	11,510	—	—	—	16,268
Substandard	7,192	1,422	2,009	—	—	299	10,922
Total loans	$279,360	$123,599	$260,198	$25,736	$2,148	$7,543	$698,584

(1) Net of LIP.

	December 31, 2013						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction / Land Development	Business	Consumer	Total [1]
	(In thousands)						
Risk Rating:							
Pass	$265,511	$114,525	$229,149	$22,904	$1,142	$8,934	$642,165
Special mention	5,825	1,203	15,134	—	—	1	22,163
Substandard	9,338	1,453	3,119	223	—	266	14,399
Total loans	$280,674	$117,181	$247,402	$23,127	$1,142	$9,201	$678,727

(1) Net of LIP.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 6 - Other Real Estate Owned

The following table is a summary of OREO during the periods shown:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Balance at beginning of period	$10,114	$14,226	$11,465	$17,347
Loans transferred to OREO	193	1,047	1,823	6,416
Capitalized (reimbursed) improvements	68	(5)	120	33
Dispositions of OREO, net	(496)	(2,533)	(3,241)	(10,840)
Market value adjustments	(60)	(135)	(348)	(356)
Balance at end of period	$9,819	$12,600	$9,819	$12,600

We sold $496,000 of OREO during the third quarter of 2014, which was comprised of three properties and generated a net gain of $15,000. OREO includes properties acquired by the Company through foreclosure and deed in lieu of foreclosure. OREO at September 30, 2014 consisted of $791,000 in one-to-four family residential homes, $8.5 million in commercial real estate properties, and $536,000 in construction/land development projects.

Note 7 - Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The Company determines the fair values of its financial instruments based on the fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair values. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect its estimate for market assumptions.

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability using one of the three valuation techniques. Inputs can be observable or unobservable. Observable inputs are those assumptions that market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from an independent source. Unobservable inputs are assumptions based on the Company's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy:

- Level 1 - Quoted prices for identical instruments in active markets.
- Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable.
- Level 3 - Instruments whose significant value drivers are unobservable.

The tables below present the balances of assets measured at fair value on a recurring basis (there were no transfers between Level 1, Level 2 and Level 3 recurring measurements) at the dates indicated:

26

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Fair Value Measurements at September 30, 2014			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Investments available-for-sale:				
Mortgage-backed investments:				
Fannie Mae	$42,622	$—	$42,622	$—
Freddie Mac	22,962	—	22,962	—
Ginnie Mae	27,700	—	27,700	—
Municipal bonds	643	—	643	—
U.S. Government agencies	16,461	—	16,461	—
Corporate bonds	14,069	—	14,069	—
Total	$124,457	$—	$124,457	$—

	Fair Value Measurements at December 31, 2013			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Investments available-for-sale:				
Mortgage-backed investments:				
Fannie Mae	$46,232	$—	$46,232	$—
Freddie Mac	25,856	—	25,856	—
Ginnie Mae	33,873	—	33,873	—
Municipal bonds	1,850	—	1,850	—
U.S. Government agencies	22,704	—	22,704	—
Corporate bonds	13,849	—	13,849	—
Total	$144,364	$—	$144,364	$—

The estimated fair value of Level 2 investments is based on quoted prices for similar investments in active markets, identical or similar investments in markets that are not active and model-derived valuations whose inputs are observable.

The tables below present the balances of assets measured at fair value on a nonrecurring basis at September 30, 2014, and December 31, 2013.

	Fair Value Measurements at September 30, 2014			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

	(In thousands)			
Impaired loans (included in loans receivable, net) [1]	$55,755	$—	$—	$55,755
OREO	9,819	—	—	9,819
Total	$65,574	$—	$—	$65,574

____

[1] Total fair value of impaired loans is net of $1.6 million of specific reserves on performing TDRs.

27

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Fair Value Measurements at December 31, 2013			
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Impaired loans (included in loans receivable, net) [(1)]	$61,985	$—	$—	$61,985
OREO	11,465	—	—	11,465
Total	$73,450	$—	$—	$73,450

____

(1) Total fair value of impaired loans is net of $2.2 million of specific reserves on performing TDRs

The fair value of impaired loans is calculated using the collateral value method or on a discounted cash flow basis. Inputs used in the collateral value method include appraised values, less estimated costs to sell. Some of these inputs may not be observable in the marketplace. Appraised values may be discounted based on management's knowledge of the marketplace, subsequent changes in market conditions, or management's knowledge of the borrower.

OREO properties are measured at the lower of their carrying amount or fair value, less estimated costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at September 30, 2014, and December 31, 2013.

	September 30, 2014			
	Fair Value	Valuation Technique	Unobservable Input(s)	Range (Weighted Average)
	(Dollars in thousands)			
Impaired Loans	$55,755	Market approach	Appraised value discounted by market or borrower conditions	0% - 23.07% (0.61%)
OREO	$9,819	Market approach	Appraised value less selling costs	0% - 14.22% (0.08%)

	December 31, 2013			
	Fair Value	Valuation Technique	Unobservable Input(s)	Range (Weighted Average)
	(Dollars in thousands)			
Impaired Loans	$61,985	Market approach	Appraised value discounted by market or borrower conditions	0% - 72.29% (2.71%)
OREO	$11,465	Market approach	Appraised value less selling costs	0% - 26.35% (4.59%)

The carrying amounts and estimated fair values of financial instruments were as follows at the dates indicated:

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	September 30, 2014				
		Estimated	Fair Value Measurements Using:		
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash on hand and in banks	$5,239	$5,239	$5,239	$—	$—
Interest-earning deposits	50,388	50,388	50,388	—	—
Investments available-for-sale	124,457	124,457	—	124,457	—
Loans receivable, net	684,166	698,606	—	—	698,606
FHLB stock	6,815	6,815	—	6,815	—
Accrued interest receivable	3,401	3,401	—	3,401	—
Financial Liabilities:					
Deposits	192,525	192,525	192,525	—	—
Certificates of deposit, retail	365,302	366,323	—	366,323	—
Certificates of deposit, brokered	32,538	32,778		32,778	
Advances from the FHLB	135,500	135,158	—	135,158	—
Accrued interest payable	130	130	—	130	—

	December 31, 2013				
		Estimated	Fair Value Measurements Using:		
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash on hand and in banks	$6,074	$6,074	$6,074	$—	$—
Interest-earning deposits	49,501	49,501	49,501	—	—
Investments available-for-sale	144,364	144,364	—	144,364	—
Loans receivable, net	663,153	680,622	—	—	680,622
FHLB stock	7,017	7,017	—	7,017	—
Accrued interest receivable	3,698	3,698	—	3,698	—
Financial Liabilities:					
Deposits	201,658	201,658	201,658	—	—
Certificates of deposit, retail	410,407	413,417	—	413,417	—
Advances from the FHLB	119,000	118,610	—	118,610	—
Accrued interest payable	88	88	—	88	—

Fair value estimates, methods, and assumptions are set forth below for the Company's financial instruments:

- Financial instruments with book value equal to fair value: The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value. These instruments include cash on hand and in banks, interest-earning deposits, FHLB stock, accrued interest receivable, accrued interest payable, and investment transactions payable. FHLB stock is not publicly-traded, however it may be redeemed on a dollar-for-dollar basis, for any amount the Bank is not required to hold, subject to the FHLB’s discretion. The fair value is therefore equal to the book value.

29

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

- Investments available-for-sale: The fair value of all investments, excluding FHLB stock, was based upon quoted market prices for similar investments in active markets, identical or similar investments in markets that are not active, and model-derived valuations whose inputs are observable.

- Loans receivable: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans is estimated using discounted cash flow analysis, utilizing interest rates that would be offered for loans with similar terms to borrowers of similar credit quality. As a result of current market conditions, cash flow estimates have been further discounted to include a credit factor. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

- Liabilities: The fair value of deposits with no stated maturity, such as statement savings, NOW and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows using current interest rates for certificates of deposit with similar remaining maturities. The fair value of FHLB advances is estimated based on discounting the future cash flows using current interest rates for debt with similar remaining maturities.

- Off balance sheet commitments: No fair value adjustment is necessary for commitments made to extend credit, which represents commitments for loan originations or for outstanding commitments to purchase loans. These commitments are at variable rates, are for loans with terms of less than one year and have interest rates which approximate prevailing market rates, or are set at the time of loan closing.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that are not considered financial instruments.

Note 8 - Federal Home Loan Bank Stock

At September 30, 2014, the Bank held $6.8 million of FHLB stock, carried at par value ($100 per share). Ownership of FHLB stock is restricted to the FHLB and member institutions and can only be purchased and redeemed at par.

Management evaluates FHLB stock for impairment. The determination of whether this investment is impaired is based on the Bank's assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

Prior to 2014, the FHLB announced that the Federal Housing Finance Agency had granted it the authority to repurchase up to $25 million in excess capital stock per quarter and pay quarterly dividends, provided that the FHLB's financial condition, measured primarily by the ratio of market value of equity-to-par value of capital stock, does not deteriorate. As a result, the FHLB repurchased shares on a pro-rata basis, at par value, from its shareholders, including 690 shares from the Bank, during the third quarter of 2014 and 2,020 shares from the Bank during the nine months ended September 30, 2014. During the three and nine months ended September 30, 2013, the FHLB repurchased 658 and 1,976 shares, respectively, at par value, from the Bank.

During the three and nine months ended September 30, 2014, the Bank received $1,734 and $5,251 in dividends from the FHLB, respectively.

Note 9- Stock-Based Compensation

In June 2008, First Financial Northwest's shareholders approved the First Financial Northwest, Inc. 2008 Equity Incentive Plan (“Plan”). The Plan provides for the grant of stock options, restricted stock and stock appreciation rights.

Total compensation expense for the Plan was $104,000 and $360,000 for the three months ended September 30, 2014, and 2013, respectively, generating a related income tax benefit of $36,000 and $126,000 for the three months ended September 30, 2014, and 2013, respectively. Total compensation expense for the Plan was $275,000 and $1.3 million for the nine months

30

ended September 30, 2014, and 2013, respectively, generating a related income tax benefit of $96,000 and $465,000 for the nine months ended September 30, 2014, and 2013, respectively. Compensation expense decreased considerably from 2013 to 2014 as the Plan participants with the greatest holdings, collectively, became fully vested in 2013.

Stock Options

The Plan authorizes the grant of stock options totaling 2,285,280 shares to Company directors, advisory directors, officers and employees. Option awards are granted with an exercise price equal to the market price of First Financial Northwest's common stock at the grant date. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date, and a contractual life of 10 years. Any unexercised stock options will expire ten years after the grant date or sooner in the event of the award recipient’s death, disability or termination of service with the Company or the Bank. First Financial Northwest has a policy of issuing new shares from authorized but unissued common stock upon the exercise of stock options. At September 30, 2014, remaining options for 671,756 shares of common stock were available for grant under the Plan.

The fair value of each option award is estimated on the grant date using a Black-Scholes model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The historical volatility of the Company's stock price over a specified period of time is used for the expected volatility assumption. First Financial Northwest bases the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. First Financial Northwest elected to use the “Share-Based Payments” method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at the midpoint.

A summary of the Company’s stock option plan awards and activity for the three and nine months ended September 30, 2014, follows:

	For the three months ended September 30, 2014			
	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at July 1, 2014	871,855	$ 9.38		$1,410,163
Granted	95,000	10.78		—
Exercised	(9,200)	9.78		7,084
Forfeited or expired	—	—		—
Outstanding at September 30, 2014	957,655	9.52	5.50	781,642
Expecting to vest assuming a 3% forfeiture rate over the vesting term	949,765	9.52	5.47	775,324
Exercisable at September 30, 2014	694,655	9.41	4.22	571,042

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	For the nine months ended September 30, 2014			
	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at January 1, 2014	1,203,535	$ 9.49		$1,103,186
Granted	95,000	10.78		—
Exercised	(340,880)	9.78		272,318
Forfeited or expired	—			—
Outstanding at September 30, 2014	957,655	9.52	5.50	781,642
Expected to vest assuming a 3% forfeiture rate over the vesting term	949,765	9.52	5.47	775,324
Exercisable at September 30, 2014	694,655	9.41	4.22	571,042

As of September 30, 2014, there was $847,354 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 4.12 years. For the three and nine months ended September 30, 2014, the weighted-average fair value for stock options granted was $4.13. The weighted-average fair value for stock options granted during the same periods in 2013 was $3.70.

Restricted Stock Awards

The Plan authorizes the grant of restricted stock awards amounting to 914,112 shares to directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the grant date. The restricted stock awards' fair value is equal to the stock price on the grant date. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date. At September 30, 2014, remaining restricted stock awards for 74,478 shares were available to be awarded. Shares that have been awarded but have not yet vested totaled 82,000 as of September 30, 2014, and are held in a reserve account until they are vested.

A summary of changes in nonvested restricted stock awards for the three and nine months ended September 30, 2014, follows:

	For the three months ended September 30, 2014	
	Shares	Weighted-Average Grant Date Fair Value
Nonvested at July 1, 2014	97,000	$8.52
Granted	—	
Vested	(15,000)	8.97
Forfeited	—	
Nonvested at September 30, 2014	82,000	8.44
Expected to vest assuming a 3% forfeiture rate over the vesting term	79,540	

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	For the nine months ended September 30, 2014	
	Shares	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2014	103,400	$8.24
Granted	—	—
Vested	(21,400)	7.49
Forfeited	—	—
Nonvested at September 30, 2014	82,000	8.44
Expected to vest assuming a 3% forfeiture rate over the vesting term	79,540	

During the three and nine months ended September 30, 2014, there were no restricted stock awards granted. During the three and nine months ended September 30, 2013, 25,000 shares of restricted stock were granted at a weighted-average fair value of $10.88. As of September 30, 2014, there was $602,600 of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.19 years. The total fair value of shares vested during the quarters ended September 30, 2014, and 2013 was $135,000 and $1.4 million, respectively. The total fair value of shares vested during the nine months ended September 30, 2014, and 2013 was $160,000 and $1.5 million, respectively.

Note 10 - Federal Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal income tax laws, and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax assets and liabilities.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. Each quarter, we consider positive and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty regarding short-term future earnings. We further consider that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing these various factors, in 2010 we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential. During 2013, management determined that a full valuation allowance was no longer appropriate and reversed all but $431,000 of the deferred tax asset valuation allowance as of December 31, 2013. In reaching this determination, management considered the scheduled reversal of deferred tax assets and liabilities, taxes paid in carryback years, available tax planning strategies and projected taxable income.

The Company has prepared federal tax returns through December 31, 2013, at which time the net operating loss carryforward was $21.3 million which will begin to expire in 2030.

Note 11 - Earnings Per Share

Per the provisions of FASB ASC 260, Earnings Per Share, nonvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of EPS pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. ESOP shares are considered outstanding for basic and diluted earnings per share when the shares are committed to be released. Certain of the Company's nonvested restricted stock awards qualify as participating securities.

Net income is allocated between the common stock and participating securities pursuant to the two-class method, based on their rights to receive dividends, participate in earnings, or absorb losses. Basic earnings per common shares is computed by dividing net earnings available to common shareholders by the weighted-average number of common shares outstanding during the period, excluding participating nonvested restricted shares.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Dollars in thousands, except share data)			
Net income	$2,735	$2,612	$7,747	$20,532
Less: Earnings allocated to participating securities	$(14)	$—	$(40)	$—
Earnings allocated to common shareholders	$2,721	$2,612		