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First Financial Northwest, Inc.  
Form 10-Q  
August 06, 2015

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

FORM 10-Q

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

For the quarterly period ended June 30, 2015

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  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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         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  

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of August 3, 2015, 14,417,827 shares of the issuer's common stock, \$0.01 par value per share, were outstanding.

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FORM 10-Q  
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## FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

## Part 1. Financial Information

## Item 1. Financial Statements

|   | June 30, 2015<br>(Unaudited) | December 31, 2014 |
|---|------------------------------|-------------------|
| Assets  |                              |                   |
| Cash on hand and in banks   | \$5,550                      | \$5,920           |
| Interest-earning deposits   | 101,424                      | 98,129            |
| Investments available-for-sale, at fair value   | 116,913                      | 120,374           |
| Loans receivable, net of allowance of \$10,603 and \$10,491, respectively   | 659,273                      | 663,938           |
| Federal Home Loan Bank ("FHLB") stock, at cost  | 6,537                        | 6,745             |
| Accrued interest receivable   | 3,033                        | 3,265             |
| Deferred tax assets, net  | 6,195                        | 8,338             |
| Other real estate owned ("OREO")  | 4,416                        | 9,283             |
| Premises and equipment, net   | 16,934                       | 16,734            |
| Bank owned life insurance ("BOLI")  | 22,932                       | 2,776             |
| Prepaid expenses and other assets   | 1,225                        | 1,495             |
| Total assets  | \$944,432                    | \$936,997         |
| Liabilities and Stockholders' Equity  |                              |                   |
| Deposits:   |                              |                   |
| Interest-bearing deposits   | \$603,177                    | \$599,773         |
| Noninterest-bearing deposits  | 20,531                       | 14,354            |
| Total deposits  | 623,708                      | 614,127           |
| Advances from the FHLB  | 135,500                      | 135,500           |
| Advance payments from borrowers for taxes and insurance   | 1,581                        | 1,707             |
| Accrued interest payable  | 145                          | 142               |
| Investment trades payable   | 578                          | —                 |
| Other liabilities   | 5,349                        | 4,109             |
| Total liabilities   | 766,861                      | 755,585           |
| 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 14,552,324 shares at June 30, 2015, and 15,167,381 shares at December 31, 2014 | 146                          | 151               |
| Additional paid-in capital  | 146,240                      | 153,395           |
| Retained earnings, substantially restricted   | 39,900                       | 36,969            |
| Accumulated other comprehensive loss, net of tax  | (533                         | ) (357            |
| Unearned Employee Stock Ownership Plan ("ESOP") shares  | (8,182                       | ) (8,746          |
| Total stockholders' equity  | 177,571                      | 181,412           |
| Total liabilities and stockholders' equity  | \$944,432                    | \$936,997         |

See accompanying selected notes to consolidated financial statements.



## FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

## Consolidated Income Statements

(Dollars in thousands, except per share data)

(Unaudited)

|  | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|--|-----------------------------|------------|---------------------------|------------|
|  | 2015                        | 2014       | 2015                      | 2014       |
| Interest income  |                             |            |                           |            |
| Loans, including fees  | \$8,658                     | \$9,087    | \$17,234                  | \$18,113   |
| Investments available-for-sale                                   | 495                         | 585        | 1,007                     | 1,189      |
| Interest-earning deposits  | 65                          | 22         | 129                       | 42         |
| Dividends on FHLB stock  | 3                           | 1          | 5                         | 3          |
| Total interest income  | \$9,221                     | \$9,695    | \$18,375                  | \$19,347   |
| Interest expense   |                             |            |                           |            |
| Deposits   | 1,333                       | 1,238      | 2,647                     | 2,585      |
| FHLB advances  | 320                         | 279        | 638                       | 530        |
| Total interest expense   | \$1,653                     | \$1,517    | \$3,285                   | \$3,115    |
| Net interest income  | 7,568                       | 8,178      | 15,090                    | 16,232     |
| Recapture of provision for loan losses                           | (500                        | ) (100     | ) (600                    | ) (600     |
| Net interest income after recapture of provision for loan losses | \$8,068                     | \$8,278    | \$15,690                  | \$16,832   |
| Noninterest income   |                             |            |                           |            |
| Net loss on sale of investments                                  | —                           | (20        | ) —                       | (20        |
| Other  | 357                         | 108        | 448                       | 176        |
| Total noninterest income   | \$357                       | \$88       | \$448                     | \$156      |
| Noninterest expense  |                             |            |                           |            |
| Salaries and employee benefits                                   | 3,251                       | 2,860      | 6,665                     | 5,775      |
| Occupancy and equipment  | 314                         | 332        | 652                       | 678        |
| Professional fees  | 458                         | 394        | 812                       | 751        |
| Data processing  | 188                         | 154        | 348                       | 332        |
| (Gain) loss on sale of OREO property, net                        | (2                          | ) 36       | (531                      | ) 107      |
| OREO market value adjustments                                    | (46                         | ) 92       | 4                         | 288        |
| OREO related expenses (reimbursements), net                      | 41                          | 78         | (7                        | ) 139      |
| Regulatory assessments   | 116                         | 104        | 232                       | 182        |
| Insurance and bond premiums                                      | 89                          | 103        | 181                       | 176        |
| Marketing  | 54                          | 37         | 87                        | 62         |
| Other general and administrative                                 | 411                         | 512        | 721                       | 736        |
| Total noninterest expense  | \$4,874                     | \$4,702    | \$9,164                   | \$9,226    |
| Income before federal income tax provision                       | 3,551                       | 3,664      | 6,974                     | 7,762      |
| Federal income tax provision                                     | 1,183                       | 1,297      | 2,377                     | 2,750      |
| Net income   | \$2,368                     | \$2,367    | \$4,597                   | \$5,012    |
| Basic earnings per share   | \$0.17                      | \$0.16     | \$0.33                    | \$0.33     |
| Diluted earnings per share                                       | \$0.17                      | \$0.16     | \$0.33                    | \$0.33     |
| Weighted average number of basic shares outstanding              | 13,756,336                  | 15,042,712 | 13,895,872                | 15,146,999 |
| Weighted average number of diluted shares outstanding            | 13,916,314                  | 15,120,938 | 14,057,198                | 15,224,155 |

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 |         | Six Months     |           |
|---|--------------------|---------|----------------|-----------|
|   | June 30,           |         | Ended June 30, |           |
|   | 2015               | 2014    | 2015           | 2014      |
| Net income  | \$2,368            | \$2,367 | \$4,597        | \$5,012   |
| Other comprehensive income, before tax:   |                    |         |                |           |
| Unrealized holding gains (losses) on investments available-for-sale (net of tax provision of (\$263) and \$439 for the second quarter of 2015 and 2014, respectively, and (\$94) and \$768 for the first six months of 2015 and 2014, respectively) | (488               | ) 815   | (176           | ) 1,425   |
| Reclassification adjustment for net losses realized in income (net of tax provision of \$7 for the three and six months ended June 30, 2014)  | \$—                | \$13    | \$—            | \$13      |
| Other comprehensive (loss) income, net of tax   | \$(488             | ) \$828 | \$(176         | ) \$1,438 |
| Total comprehensive income  | \$1,880            | \$3,195 | \$4,421        | \$6,450   |

See accompanying selected notes to consolidated financial statements.



## FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

## Consolidated Statements of Stockholders' Equity

(Dollars in thousands except share data)

(Unaudited)

|   | Shares     | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss),<br>net of tax | Unearned<br>ESOP<br>Shares | Total<br>Stockholders'<br>Equity |
|---|------------|-----------------|----------------------------------|----------------------|--|----------------------------|----------------------------------|
| Balances at December 31, 2013   | 16,392,139 | \$ 164          | \$ 166,866                       | \$ 29,220            | \$ (2,020 )  | \$ (9,875 )                | \$ 184,355                       |
| Other comprehensive income  | —          | —               | —                                | 5,012                | 1,438  | —                          | 6,450                            |
| Cash dividend declared and paid<br>(\$0.10 per share)                   | —          | —               | —                                | (1,508 )             | —  | —                          | (1,508 )                         |
| Exercise of stock options   | 331,680    | 3               | 3,240                            | —                    | —  | —                          | 3,243                            |
| Purchase and retirement of<br>common stock                              | (992,840 ) | (10 )           | (10,813 )                        | —                    | —  | —                          | (10,823 )                        |
| Compensation related to stock<br>options and restricted stock<br>awards | —          | —               | 172                              | —                    | —  | —                          | 172                              |
| Allocation of 56,427 ESOP<br>shares                                     | —          | —               | 30                               | —                    | —  | 565                        | 595                              |
| Balances at June 30, 2014   | 15,730,979 | \$ 157          | \$ 159,495                       | \$ 32,724            | \$ (582 )  | \$ (9,310 )                | \$ 182,484                       |

|   | Shares     | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss), net<br>of tax | Unearned<br>ESOP<br>Shares | Total<br>Stockholders'<br>Equity |
|---|------------|-----------------|----------------------------------|----------------------|--|----------------------------|----------------------------------|
| Balances at December 31, 2014   | 15,167,381 | \$ 151          | \$ 153,395                       | \$ 36,969            | \$ (357 )  | \$ (8,746 )                | \$ 181,412                       |
| Other comprehensive income  | —          | —               | —                                | 4,597                | (176 )   | —                          | 4,421                            |
| Cash dividend declared and paid<br>(\$0.12 per share)                   | —          | —               | —                                | (1,666 )             | —  | —                          | (1,666 )                         |
| Exercise of stock options   | 50,000     | 1               | 489                              | —                    | —  | —                          | 490                              |
| Purchase and retirement of<br>common stock                              | (665,057 ) | (6 )            | (7,980 )                         | —                    | —  | —                          | (7,986 )                         |
| Compensation related to stock<br>options and restricted stock<br>awards | —          | —               | 219                              | —                    | —  | —                          | 219                              |
| Allocation of 56,426 ESOP<br>shares                                     | —          | —               | 117                              | —                    | —  | 564                        | 681                              |
| Balances at June 30, 2015   | 14,552,324 | \$ 146          | \$ 146,240                       | \$ 39,900            | \$ (533 )  | \$ (8,182 )                | \$ 177,571                       |

See accompanying selected notes to consolidated financial statements.

## FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

|   | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2015                      | 2014      |
| Cash flows from operating activities:   |                           |           |
| Net income  | \$4,597                   | \$5,012   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |           |
| Recapture of provision for loan losses  | (600                      | ) (600    |
| OREO market value adjustments   | 4                         | 288       |
| (Gain) loss on sale of OREO property, net   | (531                      | ) 107     |
| Loss on sale of investments available-for-sale                                    | —                         | 20        |
| Loss on sale of premises and equipment  | —                         | 11        |
| Depreciation of premises and equipment  | 364                       | 382       |
| Amortization of premiums and discounts on investments available-for-sale, net     | 586                       | 750       |
| Deferred federal income taxes   | 2,237                     | 2,633     |
| Allocation of ESOP shares   | 681                       | 595       |
| Stock compensation expense  | 219                       | 172       |
| Change in cash surrender value of BOLI  | (156                      | ) —       |
| Changes in operating assets and liabilities:                                      |                           |           |
| Prepaid expenses and other assets   | 270                       | (252      |
| Net increase in advance payments from borrowers for taxes and insurance           | (126                      | ) (263    |
| Accrued interest receivable   | 232                       | 134       |
| Accrued interest payable  | 3                         | 17        |
| Other liabilities   | 1,240                     | 415       |
| Net cash provided by operating activities   | \$9,020                   | \$9,421   |
| Cash flows from investing activities:   |                           |           |
| Capital expenditures related to OREO  | —                         | (52       |
| Proceeds from sales of OREO properties  | 5,535                     | 2,638     |
| Proceeds from calls and sales of investments available-for-sale                   | 1,550                     | 6,380     |
| Principal repayments on investments available-for-sale                            | 9,575                     | 10,583    |
| Purchases of investments available-for-sale                                       | (8,520                    | ) —       |
| Investments available-for-sale transaction payable                                | 578                       | —         |
| Net increase in loans receivable  | 5,124                     | (14,332   |
| FHLB stock redemption   | 208                       | 133       |
| Purchases of premises and equipment   | (564                      | ) (126    |
| Purchase of BOLI  | (20,000                   | ) —       |
| Net cash (used) provided by investing activities                                  | \$(6,514                  | ) \$5,224 |
| Cash flows from financing activities:   |                           |           |
| Net increase (decrease) in deposits   | 9,581                     | (36,946   |
| Advances from the FHLB  | —                         | 16,500    |
| Proceeds from stock options exercises   | 490                       | 3,243     |
| Repurchase and retirement of common stock   | (7,986                    | ) (10,823 |
| Dividends paid  | (1,666                    | ) (1,508  |
| Net cash provided (used) by financing activities                                  | \$419                     | \$(29,534 |

Continued



## FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

|  | Six Months Ended June 30, 2015 |            |
|--|--------------------------------|------------|
|  | 2015                           | 2014       |
| Net increase (decrease) in cash and cash equivalents                               | \$2,925                        | \$(14,889) |
| Cash and cash equivalents at beginning of quarter                                  | 104,049                        | 55,575     |
| Cash and cash equivalents at end of quarter  | \$106,974                      | \$40,686   |
| Supplemental disclosures of cash flow information:                                 |                                |            |
| Cash paid during the period for:   |                                |            |
| Interest paid  | \$3,282                        | \$3,098    |
| Federal income taxes paid  | 126                            | 109        |
| Noncash items:   |                                |            |
| Loans transferred to OREO, net of deferred loan fees and allowance for loan losses | \$141                          | \$1,630    |
| Change in unrealized loss on investments available for sale                        | (270)                          | ) 2,213    |

See accompanying selected notes to consolidated financial statements.

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 bank holding company, having converted from a savings and loan holding company as of March 31, 2015, subject to regulation by the Federal Reserve Bank of San Francisco. 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 Financial Northwest has announced that as of August 21, 2015, the Bank is changing its name to "First Financial Northwest Bank". In addition, the Bank has received regulatory approvals to open a branch office in Mill Creek, Washington, which we expect to contribute to growth in our market presence in Snohomish County. This new branch office, scheduled to open in the third quarter of 2015, will be smaller than traditional bank offices, utilizing technology alternatives in an effort to manage expenses with this expansion.

The Bank is a portfolio lender, originating one-to-four family residential, multifamily, commercial real estate, construction/land development, business, and consumer loans. Our current business strategy emphasizes commercial real estate, construction, one-to-four family residential, and multifamily lending, funded primarily by deposits from the general public, supplemented by borrowings from the Federal Home Loan Bank of Des Moines and deposits raised in the national brokered deposit market.

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 interim consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2014, as filed with the SEC. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the unaudited interim 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 six months ended June 30, 2015, are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. 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 other real estate owned ("OREO") and the underlying collateral of impaired loans, 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 its portfolio in its primary market area. Substantially all income is derived from a diverse base of commercial, multifamily, and residential real estate loans, consumer lending activities, and investments.

Certain amounts in the unaudited interim 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.

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

Note 3 - Recently Issued Accounting Pronouncements

In January 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20). The ASU eliminated from GAAP the concept of extraordinary items. Under subtopic 225-20, entities were required to separately classify, present, and disclose extraordinary events and transactions that were both unusual in nature and infrequent in occurrence. This amendment will save time and reduce costs for preparers, as well as alleviate uncertainty for auditors and regulators in evaluating potentially extraordinary items. The amendment is effective for fiscal years and interim reporting periods after December 15, 2015. It may be applied prospectively and retrospectively to all reporting periods presented in the financial statements. The adoption of ASU No. 2015-01 is not expected to have a material impact on the Company's consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, Consolidation (Topic 810) - Amendments to the Consolidation Analysis. The amendments in this ASU affect limited partnerships and similar legal entities, evaluation of fees paid as a variable interest, the effect of fee arrangements and related parties on the primary beneficiary determination, and evaluation of certain investment funds. Under the revised consolidation model, all legal entities are subject to reevaluation. The amendments are effective for public business entities for fiscal years and interim reporting periods beginning after December 15, 2015. They may be applied retrospectively and early adoption is permitted. The adoption of ASU No. 2015-02 is not expected to have a material impact on the Company's consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, Intangibles--Goodwill and Other--Internal-Use Software (Subtopic 350-40). The amendments in this ASU helps entities evaluate the accounting for fees paid for a cloud computing arrangement by providing guidance as to whether the arrangement includes a software license. If the arrangement does not include a software license, then the arrangement should be accounted for as a service contract. Prior to the release of this standard, stakeholders were concerned the absence of specific guidance resulted in diversity of practice and unnecessary costs. These amendments will be effective for annual and interim periods beginning after December 15, 2015. The amendments may be adopted prospectively or retrospectively. The adoption of ASU No. 2015-05 is not expected to have a material impact on the Company's consolidated financial statements.

In June 2015, the FASB issued ASU No. 2015-10, Technical Corrections and Improvements. The amendments in this update facilitate updates for technical corrections, clarifications, and improvements to the FASB Accounting Standards Codification. The amendments in this update fall into one of the following categories: amendments related to differences between original guidance and the codification, guidance clarification and reference corrections, simplification, and minor improvements. The amendments in this update requiring transition guidance are effective for fiscal years and interim periods beginning after December 15, 2015, with early adoption permitted. The adoption of ASU No. 2015-10 is not expected to 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:

| June 30, 2015     |                              |                               |            |
|-------------------|------------------------------|-------------------------------|------------|
| Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |

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(In thousands)

Mortgage-backed investments:

|                          |           |         |        |             |
|--------------------------|-----------|---------|--------|-------------|
| Fannie Mae               | \$38,303  | \$753   | \$(81  | ) \$38,975  |
| Freddie Mac              | 22,957    | 451     | (60    | ) 23,348    |
| Ginnie Mae               | 22,812    | 97      | (151   | ) 22,758    |
| Municipal bonds          | 3,515     | 3       | (34    | ) 3,484     |
| U.S. Government agencies | 14,310    | 98      | (93    | ) 14,315    |
| Corporate bonds          | 14,052    | 30      | (49    | ) 14,033    |
| Total                    | \$115,949 | \$1,432 | \$(468 | ) \$116,913 |

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

|                              | December 31, 2014 |                              |                               |            |
|------------------------------|-------------------|------------------------------|-------------------------------|------------|
|                              | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|                              | (In thousands)    |                              |                               |            |
| Mortgage-backed investments: |                   |                              |                               |            |
| Fannie Mae                   | \$40,083          | \$863                        | \$(30)                        | \$40,916   |
| Freddie Mac                  | 21,442            | 526                          | (22)                          | 21,946     |
| Ginnie Mae                   | 26,049            | 87                           | (122)                         | 26,014     |
| Municipal bonds              | 642               | 2                            | —                             | 644        |
| U.S. Government agencies     | 16,863            | 104                          | (151)                         | 16,816     |
| Corporate bonds              | 14,061            | 39                           | (62)                          | 14,038     |
| Total                        | \$119,140         | \$1,621                      | \$(387)                       | \$120,374  |

The following tables summarize 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:

|                              | June 30, 2015       |                    |                     |                    |            |                    |
|------------------------------|---------------------|--------------------|---------------------|--------------------|------------|--------------------|
|                              | Less Than 12 Months |                    | 12 Months or Longer |                    | Total      |                    |
|                              | Fair Value          | Unrealized<br>Loss | Fair Value          | Unrealized<br>Loss | Fair Value | Unrealized<br>Loss |
|                              | (In thousands)      |                    |                     |                    |            |                    |
| Mortgage-backed investments: |                     |                    |                     |                    |            |                    |
| Fannie Mae                   | \$5,482             | \$(42)             | \$1,231             | \$(39)             | \$6,713    | \$(81)             |
| Freddie Mac                  | 5,777               | (60)               | —                   | —                  | 5,777      | (60)               |
| Ginnie Mae                   | 5,908               | (34)               | 8,591               | (117)              | 14,499     | (151)              |
| Municipal bonds              | 2,302               | (34)               | —                   | —                  | 2,302      | (34)               |
| U.S. Government agencies     | 4,650               | (70)               | 1,977               | (23)               | 6,627      | (93)               |
| Corporate bonds              | 3,031               | (10)               | 4,461               | (39)               | 7,492      | (49)               |
| Total                        | \$27,150            | \$(250)            | \$16,260            | \$(218)            | \$43,410   | \$(468)            |
|                              | December 31, 2014   |                    |                     |                    |            |                    |
|                              | Less Than 12 Months |                    | 12 Months or Longer |                    | Total      |                    |
|                              | Fair Value          | Unrealized<br>Loss | Fair Value          | Unrealized<br>Loss | Fair Value | Unrealized<br>Loss |
|                              | (In thousands)      |                    |                     |                    |            |                    |
| Mortgage-backed investments: |                     |                    |                     |                    |            |                    |
| Fannie Mae                   | \$—                 | \$—                | \$1,456             | \$(30)             | \$1,456    | \$(30)             |
| Freddie Mac                  | —                   | —                  | 1,832               | (22)               | 1,832      | (22)               |
| Ginnie Mae                   | 1,883               | (6)                | 9,952               | (116)              | 11,835     | (122)              |
| U.S. Government agencies     | 545                 | —                  | 8,096               | (151)              | 8,641      | (151)              |
| Corporate bonds              | 1,496               | (4)                | 5,942               | (58)               | 7,438      | (62)               |
| Total                        | \$3,924             | \$(10)             | \$27,278            | \$(377)            | \$31,202   | \$(387)            |

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. If the Company intends to sell a debt 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

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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. At June 30, 2015, the Company had 32 securities in an unrealized loss position, of which 13 have been in an unrealized loss position for 12 months or more. Management reviewed the financial condition of the entities issuing municipal or corporate bonds at June 30, 2015 and December 31, 2014, and determined that an OTTI charge was not warranted.

The amortized cost and estimated fair value of investments available-for-sale at June 30, 2015, 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.

|  | June 30, 2015     |            |
|--|-------------------|------------|
|  | Amortized<br>Cost | Fair Value |
|  | (In thousands)    |            |
| Due within one year                    | \$—               | \$—        |
| Due after one year through five years  | 13,570            | 13,542     |
| Due after five years through ten years | 13,971            | 13,909     |
| Due after ten years                    | 4,336             | 4,381      |
|  | 31,877            | 31,832     |
| Mortgage-backed investments            | 84,072            | 85,081     |
| Total                                  | \$115,949         | \$116,913  |

Under Washington state law, in order to participate in the public funds program the Company is required to pledge eligible securities as collateral in an amount equal to 100% of the public deposits held. Investments with market values of \$15.6 million and \$16.3 million were pledged as collateral for public deposits at June 30, 2015 and December 31, 2014, respectively, both of which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission.

For the three and six months ended June 30, 2015, we had calls on investment securities of \$1.5 million and \$1.6 million respectively, with no gain or loss. We had no sales during these periods. For the three and six months ended June 30, 2014, we sold \$5.0 million of investment securities generating a gross loss of \$20,000 and had a call of \$1.4 million with no gain or loss.

During the three and six months ended June 30, 2015, we purchased fixed rate securities of \$6.6 million and \$8.5 million, respectively. There were no purchases of investment securities during the first six months of 2014.

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## Note 5 - Loans Receivable

Loans receivable are summarized as follows at the dates indicated:

|  | June 30, 2015<br>(In thousands) | December 31, 2014 |
|--|---------------------------------|-------------------|
| One-to-four family residential:                |                                 |                   |
| Permanent owner occupied                       | \$152,764                       | \$161,013         |
| Permanent non-owner occupied                   | 105,046                         | 112,180           |
| Construction non-owner occupied <sup>(1)</sup> | —                               | 500               |
|  | 257,810                         | 273,693           |
| Multifamily:                                   |                                 |                   |
| Permanent                                      | 120,758                         | 116,014           |
| Construction <sup>(1)</sup>                    | 2,265                           | 4,450             |
|  | 123,023                         | 120,464           |
| Commercial real estate:                        |                                 |                   |
| Permanent                                      | 233,652                         | 239,211           |
| Construction <sup>(1)</sup>                    | —                               | 6,100             |
| Land <sup>(2)</sup>                            | 7,598                           | 2,956             |
|  | 241,250                         | 248,267           |
| Construction/land development:                 |                                 |                   |
| One-to-four family residential <sup>(1)</sup>  | 30,448                          | 19,860            |
| Multifamily <sup>(1)</sup>                     | 19,438                          | 17,902            |
| Commercial <sup>(1)</sup>                      | 4,300                           | 4,300             |
| Land development <sup>(2)</sup>                | 8,013                           | 8,993             |
|  | 62,199                          | 51,055            |
| Business                                       | 6,275                           | 3,783             |
| Consumer                                       | 7,051                           | 7,130             |
| Total loans                                    | 697,608                         | 704,392           |
| Less:  |                                 |                   |
| Loans in process ("LIP")                       | 25,182                          | 27,359            |
| Deferred loan fees, net                        | 2,550                           | 2,604             |
| Allowance for loan and lease losses ("ALLL")   | 10,603                          | 10,491            |
| Loans receivable, net                          | \$659,273                       | \$663,938         |

<sup>(1)</sup> Construction/land development 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 June 30, 2015, the Company had no one-to-four family residential or commercial real estate loans, and \$2.3 million or 1.8% of its total multifamily portfolio in these rollover loans. At December 31, 2014, the Company had \$6.1 million or 2.5% of the total commercial real estate portfolio and \$4.5 million or 3.7% of the total multifamily portfolio, and \$500,000 or 0.2% of the total one-to-four family residential portfolio in these rollover loans.

<sup>(2)</sup>At June 30, 2015, and December 31, 2014, \$7.6 million and \$3.0 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 June 30, 2015 and December 31, 2014, there were no loans classified as held for sale.

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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 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 June 30, 2015         |             |                           |                                      |          |          |           |
|-----------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|-----------|
|                       | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction/<br>Land<br>Development | Business | Consumer | Total     |
| ALLL:                 |  |             |                           |                                      |          |          |           |
| Beginning balance     | \$ 3,688   | \$ 1,023    | \$ 4,635                  | \$ 741                               | \$ 54    | \$ 367   | \$ 10,508 |
| Charge-offs           | —  | —           | —                         | —                                    | —        | —        | —         |
| Recoveries            | 518  | —           | 57                        | —                                    | —        | 20       | 595       |
| Provision (recapture) | (670   | ) 164       | (256                      | ) 78                                 | 135      | 49       | (500 )    |
| Ending balance        | \$ 3,536   | \$ 1,187    | \$ 4,436                  | \$ 819                               | \$ 189   | \$ 436   | \$ 10,603 |

|                          | At or For the Six Months Ended June 30, 2015           |             |                           |                                      |          |          |           |
|--------------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|-----------|
|                          | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction/<br>Land<br>Development | Business | Consumer | Total     |
| ALLL:                    |  |             |                           |                                      |          |          |           |
| Beginning balance        | \$ 3,694   | \$ 1,646    | \$ 4,597                  | \$ 355                               | \$ 47    | \$ 152   | \$ 10,491 |
| Charge-offs              | (25  | ) (281      | ) —                       | —                                    | —        | (34      | ) (340 )  |
| Recoveries               | 691  | —           | 57                        | —                                    | 3        | 301      | 1,052     |
| Provision<br>(recapture) | (824   | ) (178      | ) (218                    | ) 464                                | 139      | 17       | (600 )    |
| Ending balance           | \$ 3,536   | \$ 1,187    | \$ 4,436                  | \$ 819                               | \$ 189   | \$ 436   | \$ 10,603 |

Allowance by  
category:

|                  |          |          |          |        |        |        |          |
|------------------|----------|----------|----------|--------|--------|--------|----------|
| General reserve  | \$ 3,016 | \$ 1,184 | \$ 4,190 | \$ 819 | \$ 189 | \$ 394 | \$ 9,792 |
| Specific reserve | 520      | 3        | 246      | —      | —      | 42     | 811      |

Loans: <sup>(1)</sup>

|   |            |            |            |           |          |          |            |
|---|------------|------------|------------|-----------|----------|----------|------------|
| Total loans                               | \$ 257,810 | \$ 122,481 | \$ 241,250 | \$ 37,559 | \$ 6,275 | \$ 7,051 | \$ 672,426 |
| Loans with general<br>valuation allowance | 219,369    | 119,189    | 233,078    | 37,559    | 6,275    | 6,858    | 622,328    |

<sup>(2)</sup>

|   |        |       |       |   |   |     |        |
|---|--------|-------|-------|---|---|-----|--------|
| Loans with specific reserves <sup>(3)</sup> | 38,441 | 3,292 | 8,172 | — | — | 193 | 50,098 |
|---|--------|-------|-------|---|---|-----|--------|

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

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|                          | At or For the Three Months Ended June 30, 2014         |             |                           |                                      |          |          |          |
|--------------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|----------|
|                          | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction/<br>Land<br>Development | Business | Consumer | Total    |
| ALLL:                    |  |             |                           |                                      |          |          |          |
| Beginning balance        | \$4,575  | \$1,406     | \$5,536                   | \$388                                | \$7      | \$181    | \$12,093 |
| Charge-offs              | (57)   | ) —         | —                         | —                                    | —        | (23)     | ) (80)   |
| Recoveries               | 34   | —           | —                         | —                                    | 1        | 3        | 38       |
| Provision<br>(recapture) | (175)  | ) 27        | 86                        | (55)                                 | ) 3      | 14       | (100)    |
| Ending balance           | \$4,377  | \$1,433     | \$5,622                   | \$333                                | \$11     | \$175    | \$11,951 |

|                          | At or For the Six Months Ended June 30, 2014           |             |                           |                                      |          |          |          |
|--------------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|----------|
|                          | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction/<br>Land<br>Development | Business | Consumer | Total    |
| ALLL:                    |  |             |                           |                                      |          |          |          |
| Beginning balance        | \$5,141  | \$1,377     | \$5,881                   | \$399                                | \$14     | \$182    | \$12,994 |
| Charge-offs              | (75)   | ) —         | (311)                     | ) (223)                              | ) —      | (24)     | ) (633)  |
| Recoveries               | 34   | —           | 151                       | —                                    | 1        | 4        | 190      |
| Provision<br>(recapture) | (723)  | ) 56        | (99)                      | ) 157                                | (4)      | ) 13     | (600)    |
| Ending balance           | \$4,377  | \$1,433     | \$5,622                   | \$333                                | \$11     | \$175    | \$11,951 |

Allowance by  
category:

|                  |         |         |         |       |      |       |         |
|------------------|---------|---------|---------|-------|------|-------|---------|
| General reserve  | \$2,932 | \$1,401 | \$5,071 | \$333 | \$11 | \$175 | \$9,923 |
| Specific reserve | 1,445   | 32      | 551     | —     | —    | —     | 2,028   |

Loans: <sup>(1)</sup>

|             |         |         |         |        |     |       |         |
|-------------|---------|---------|---------|--------|-----|-------|---------|
| Total loans | 272,065 | 129,639 | 259,701 | 20,680 | 897 | 8,149 | 691,131 |
|-------------|---------|---------|---------|--------|-----|-------|---------|

|  |         |         |         |        |     |       |         |
|--|---------|---------|---------|--------|-----|-------|---------|
| Loans with general<br>valuation allowance <sup>(2)</sup> | 225,319 | 127,225 | 249,818 | 20,680 | 897 | 8,106 | 632,045 |
|--|---------|---------|---------|--------|-----|-------|---------|

|  |        |       |       |   |   |    |        |
|--|--------|-------|-------|---|---|----|--------|
| Loans with specific<br>reserves <sup>(3)</sup> | 46,746 | 2,414 | 9,883 | — | — | 43 | 59,086 |
|--|--------|-------|-------|---|---|----|--------|

(1) Net of LIP.

(2) Loans collectively evaluated for general reserves.

(3) Loans individually evaluated for specific reserves.





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Past Due Loans. Loans are considered past due if a scheduled principal or interest payment is due and unpaid for 30 days or more. At June 30, 2015, total past due loans comprised 0.54% of total loans receivable, net of LIP, as compared to 0.66% at December 31, 2014. The following tables represent a summary of the aging of loans by type at the dates indicated:

|                                 | Loans Past Due as of June 30, 2015 |            |                     | Total Past Due | Current   | Total <sup>(1) (2)</sup> |
|---------------------------------|------------------------------------|------------|---------------------|----------------|-----------|--------------------------|
|                                 | 30-59 Days                         | 60-89 Days | 90 Days and Greater |                |           |                          |
|                                 | (In thousands)                     |            |                     |                |           |                          |
| Real estate:                    |                                    |            |                     |                |           |                          |
| One-to-four family residential: |                                    |            |                     |                |           |                          |
| Owner occupied                  | \$1,352                            | \$162      | \$233               | \$1,747        | \$151,017 | \$152,764                |
| Non-owner occupied              | —                                  | —          | —                   | —              | 105,046   | 105,046                  |
| Multifamily                     | —                                  | —          | 1,683               | 1,683          | 120,798   | 122,481                  |
| Commercial real estate          | —                                  | —          | 94                  | 94             | 241,156   | 241,250                  |
| Construction/land development   | —                                  | —          | —                   | —              | 37,559    | 37,559                   |
| Total real estate               | 1,352                              | 162        | 2,010               | 3,524          | 655,576   | 659,100                  |
| Business                        | —                                  | —          | —                   | —              | 6,275     | 6,275                    |
| Consumer                        | 41                                 | 73         | —                   | 114            | 6,937     | 7,051                    |
| Total loans                     | \$1,393                            | \$235      | \$2,010             | \$3,638        | \$668,788 | \$672,426                |

(1) There were no loans 90 days and greater past due and still accruing interest at June 30, 2015.

(2) Net of LIP.

|                                 | Loans Past Due as of December 31, 2014 |            |                     | Total Past Due | Current   | Total <sup>(1) (2)</sup> |
|---------------------------------|--|------------|---------------------|----------------|-----------|--------------------------|
|                                 | 30-59 Days                             | 60-89 Days | 90 Days and Greater |                |           |                          |
|                                 | (In thousands)                         |            |                     |                |           |                          |
| Real estate:                    |  |            |                     |                |           |                          |
| One-to-four family residential: |  |            |                     |                |           |                          |
| Owner occupied                  | \$666                                  | \$575      | \$666               | \$1,907        | \$159,106 | \$161,013                |
| Non-owner occupied              | —                                      | —          | 164                 | 164            | 112,388   | 112,552                  |
| Multifamily                     | 1,965                                  | —          | —                   | 1,965          | 118,306   | 120,271                  |
| Commercial real estate          | —                                      | 325        | 11                  | 336            | 247,632   | 247,968                  |
| Construction/land development   | —                                      | —          | —                   | —              | 24,316    | 24,316                   |
| Total real estate               | 2,631                                  | 900        | 841                 | 4,372          | 661,748   | 666,120                  |
| Business                        | —                                      | —          | —                   | —              | 3,783     | 3,783                    |
| Consumer                        | —                                      | 75         | —                   | 75             | 7,055     | 7,130                    |
| Total loans                     | \$2,631                                | \$975      | \$841               | \$4,447        | \$672,586 | \$677,033                |

(1) There were no loans 90 days and greater past due and still accruing interest at December 31, 2014.

(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

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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:

|                                | June 30, 2015<br>(In thousands) | December 31, 2014 |
|--------------------------------|---------------------------------|-------------------|
| One-to-four family residential | \$252                           | \$830             |
| Multifamily                    | 1,683                           | —                 |
| Commercial real estate         | 407                             | 434               |
| Consumer                       | 73                              | 75                |
| Total nonaccrual loans         | \$2,415                         | \$1,339           |

During the three and six months ended June 30, 2015, interest income that would have been recognized had these nonaccrual loans been performing in accordance with their original terms was \$33,000 and \$56,000, respectively. For the three and six months ended June 30, 2014, lost interest on nonaccrual loans was \$33,000 and \$79,000, respectively.

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

|                              | June 30, 2015  |             | Commercial<br>Real Estate | Construction /<br>Land<br>Development | Business | Consumer | Total <sup>(1)</sup> |
|------------------------------|--|-------------|---------------------------|---------------------------------------|----------|----------|----------------------|
|                              | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily |                           |                                       |          |          |                      |
| Performing <sup>(2)</sup>    | \$257,558  | \$120,798   | \$240,843                 | \$37,559                              | \$6,275  | \$6,978  | \$670,011            |
| Nonperforming <sup>(3)</sup> | 252  | 1,683       | 407                       | —                                     | —        | 73       | 2,415                |
| Total loans                  | \$257,810  | \$122,481   | \$241,250                 | \$37,559                              | \$6,275  | \$7,051  | \$672,426            |

<sup>(1)</sup> Net of LIP.

<sup>(2)</sup> There were \$152.5 million of owner-occupied one-to-four family residential loans and \$105.1 million of non-owner occupied one-to-four family residential loans classified as performing.

<sup>(3)</sup> There were \$252,000 of owner-occupied one-to-four family residential loans and no non-owner occupied one-to-four family residential loans classified as nonperforming.

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|                                 | December 31, 2014                                      |             |                           |                                      |          |          |                      |
|---------------------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|----------------------|
|                                 | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction/<br>Land<br>Development | Business | Consumer | Total <sup>(1)</sup> |
| Performing <sup>(2)</sup>       | \$272,735  | \$120,271   | \$247,534                 | \$24,316                             | \$3,783  | \$7,055  | \$675,694            |
| Nonperforming<br><sup>(3)</sup> | 830  | —           | 434                       | —                                    | —        | 75       | 1,339                |
| Total loans                     | \$273,565  | \$120,271   | \$247,968                 | \$24,316                             | \$3,783  | \$7,130  | \$677,033            |

<sup>(1)</sup> Net of LIP.

<sup>(2)</sup> There were \$160.3 million of owner-occupied one-to-four family residential loans and \$112.4 million of non-owner occupied one-to-four family residential loans classified as performing.

<sup>(3)</sup> There were \$666,000 of owner-occupied one-to-four family residential loans and \$164,000 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 June 30, 2015, or December 31, 2014.

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

|                                  | June 30, 2015<br>Recorded<br>Investment <sup>(1)</sup><br>(In thousands) | Unpaid Principal<br>Balance <sup>(2)</sup> | Related Allowance |
|----------------------------------|--|--|-------------------|
| Loans with no related allowance: |  |  |                   |
| One-to-four family residential:  |  |  |                   |
| Owner occupied                   | \$2,958  | \$3,217                                    | \$—               |
| Non-owner occupied               | 25,663   | 25,740                                     | —                 |
| Multifamily                      | 2,102  | 2,383                                      | —                 |
| Commercial real estate           | 4,500  | 4,810                                      | —                 |
| Consumer                         | 116  | 152  | —                 |
| Total                            | 35,339   | 36,302                                     | —                 |
| Loans with an allowance:         |  |  |                   |
| One-to-four family residential:  |  |  |                   |
| Owner occupied                   | 2,135  | 2,205                                      | 98                |
| Non-owner occupied               | 7,685  | 7,683                                      | 422               |
| Multifamily                      | 1,190  | 1,190                                      | 3                 |
| Commercial real estate           | 3,672  | 3,672                                      | 246               |
| Consumer                         | 77   | 77   | 42                |
| Total                            | 14,759   | 14,827                                     | 811               |
| Total impaired loans:            |  |  |                   |
| One-to-four family residential:  |  |  |                   |
| Owner occupied                   | 5,093  | 5,422                                      | 98                |
| Non-owner occupied               | 33,348   | 33,423                                     | 422               |
| Multifamily                      | 3,292  | 3,573                                      | 3                 |
| Commercial real estate           | 8,172  | 8,482                                      | 246               |
| Consumer                         | 193  | 229  | 42                |
| Total                            | \$50,098   | \$51,129                                   | \$811             |

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

(2) Contractual loan principal balance.

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|                                  | December 31, 2014                     |  |                   |
|----------------------------------|---------------------------------------|--|-------------------|
|                                  | Recorded<br>Investment <sup>(1)</sup> | Unpaid Principal<br>Balance <sup>(2)</sup> | Related Allowance |
|                                  | (In thousands)                        |  |                   |
| Loans with no related allowance: |                                       |  |                   |
| One-to-four family residential:  |                                       |  |                   |
| Owner occupied                   | \$3,308                               | \$3,661                                    | \$—               |
| Non-owner occupied               | 29,224                                | 29,266                                     | —                 |
| Commercial real estate           | 4,553                                 | 4,851                                      | —                 |
| Consumer                         | 118                                   | 153  | —                 |
| Total                            | 37,203                                | 37,931                                     | —                 |
| Loans with an allowance:         |                                       |  |                   |
| One-to-four family residential:  |                                       |  |                   |
| Owner occupied                   | 2,554                                 | 2,624                                      | 121               |
| Non-owner occupied               | 8,652                                 | 8,704                                      | 679               |
| Multifamily                      | 2,172                                 | 2,172                                      | 27                |
| Commercial real estate           | 4,999                                 | 4,999                                      | 329               |
| Consumer                         | 79                                    | 79   | 59                |
| Total                            | 18,456                                | 18,578                                     | 1,215             |
| Total impaired loans:            |                                       |  |                   |
| One-to-four family residential:  |                                       |  |                   |
| Owner occupied                   | 5,862                                 | 6,285                                      | 121               |
| Non-owner occupied               | 37,876                                | 37,970                                     | 679               |
| Multifamily                      | 2,172                                 | 2,172                                      | 27                |
| Commercial real estate           | 9,552                                 | 9,850                                      | 329               |
| Consumer                         | 197                                   | 232  | 59                |
| Total                            | \$55,659                              | \$56,509                                   | \$1,215           |

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

(2) Contractual loan principal balance.

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The following tables present the average recorded investment in loans individually evaluated for impairment and the interest income recognized for the three and six months ended June 30, 2015 and 2014:

|                                  | Three Months Ended June 30, 2015              |                            | Six Months Ended June 30, 2015 |                            |
|----------------------------------|---|----------------------------|--------------------------------|----------------------------|
|                                  | Average Recorded Investment<br>(In thousands) | Interest Income Recognized | Average Recorded Investment    | Interest Income Recognized |
| Loans with no related allowance: |   |                            |                                |                            |
| One-to-four family residential:  |   |                            |                                |                            |
| Owner occupied                   | \$3,140                                       | \$41                       | \$3,196                        | \$82                       |
| Non-owner occupied               | 26,747  | 397                        | 27,573                         | 791                        |
| Multifamily                      | 1,893   | 7                          | 1,261                          | 15                         |
| Commercial real estate           | 4,516   | 77                         | 4,529                          | 147                        |
| Consumer                         | 117   | —                          | 117                            | 1                          |
| Total                            | 36,413  | 522                        | 36,676                         | 1,036                      |
| Loans with an allowance:         |   |                            |                                |                            |
| One-to-four family residential:  |   |                            |                                |                            |
| Owner occupied                   | 2,139   | 29                         | 2,278                          | 59                         |
| Non-owner occupied               | 7,913   | 108                        | 8,159                          | 224                        |
| Multifamily                      | 1,676   | 20                         | 1,842                          | 39                         |
| Commercial real estate           | 3,903   | 50                         | 4,268                          | 100                        |
| Consumer                         | 78  | 1                          | 78                             | 2                          |
| Total                            | 15,709  | 208                        | 16,625                         | 424                        |
| Total impaired loans:            |   |                            |                                |                            |
| One-to-four family residential:  |   |                            |                                |                            |
| Owner occupied                   | 5,279   | 70                         | 5,474                          | 141                        |
| Non-owner occupied               | 34,660  | 505                        | 35,732                         | 1,015                      |
| Multifamily                      | 3,569   | 27                         | 3,103                          | 54                         |
| Commercial real estate           | 8,419   | 127                        | 8,797                          | 247                        |
| Consumer                         | 195   | 1                          | 195                            | 3                          |
| Total                            | \$52,122                                      | \$730                      | \$53,301                       | \$1,460                    |



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|                                  | Three Months Ended June 30, 2014 |                            | Six Months Ended June 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                   | \$3,284                          | \$34                       | \$3,482                        | \$72                       |
| Non-owner occupied               | 29,201                           | 451                        | 29,061                         | 883                        |
| Multifamily                      | 225                              | —                          | 228                            | —                          |
| Commercial real estate           | 4,272                            | 44                         | 4,923                          | 82                         |
| Construction/land development    | —                                | —                          | 74                             | —                          |
| Consumer                         | 43                               | 1                          | 43                             | 1                          |
| Consumer                         | 37,025                           | 530                        | 37,811                         | 1,038                      |
| Total                            |                                  |                            |                                |                            |
| Loans with an allowance:         |                                  |                            |                                |                            |
| One-to-four family residential:  |                                  |                            |                                |                            |
| Owner occupied                   | 3,392                            | 40                         | 3,325                          | 79                         |
| Non-owner occupied               | 11,178                           | 149                        | 11,551                         | 306                        |
| Multifamily                      | 2,196                            | 37                         | 2,200                          | 71                         |
| Commercial real estate           | 7,055                            | 94                         | 7,065                          | 181                        |
| Total                            | 23,821                           | 320                        | 24,141                         | 637                        |
| Total impaired loans:            |                                  |                            |                                |                            |
| One-to-four family residential:  |                                  |                            |                                |                            |
| Owner occupied                   | 6,676                            | 74                         | 6,807                          | 151                        |
| Non-owner occupied               | 40,379                           | 600                        | 40,612                         | 1,189                      |
| Multifamily                      | 2,421                            | 37                         | 2,428                          | 71                         |
| Commercial real estate           | 11,327                           | 138                        | 11,988                         | 263                        |
| Construction/land development    | —                                | —                          | 74                             | —                          |
| Consumer                         | 43                               | 1                          | 43                             | 1                          |
| Total                            | \$60,846                         | \$850                      | \$61,952                       | \$1,675                    |

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.







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|  | Three Months Ended June 30, 2014 |   |  | Six Months Ended June 30, 2014 |   |  |
|--|----------------------------------|---|--|--------------------------------|---|--|
|  | Number of<br>Loans               | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Number of<br>Loans             | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|  | (Dollars in thousands)           |   |  |                                |   |  |
| One-to-four family residential:                      |                                  |   |  |                                |   |  |
| Principal and interest with interest rate concession | —                                | \$ —  | \$ —   | 1                              | \$ 221  | \$ 221   |
| Advancement of maturity date                         | 4                                | 772   | 772  | 4                              | 772   | 772  |
| Commercial real estate:                              |                                  |   |  |                                |   |  |
| Interest only payments with interest rate concession | 1                                | 2,004   | 2,004  | 1                              | 2,004   | 2,004  |
| Total  | 5                                | \$ 2,776  | \$ 2,776   | 6                              | \$ 2,997  | \$ 2,997   |

At June 30, 2015, 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 six months ended June 30, 2015 and 2014, 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 six months ended June 30, 2015 and 2014.

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 and six months ended June 30, 2015, and the three months ended June 30, 2014, no loans defaulted that had been modified as TDRs within the previous 12 months. For the six months ended June 30, 2014, one loan of \$430,000 that was restructured with an advancement of maturity date during the previous 12 months missed a payment, but became current the subsequent quarter.

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 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 June 30, 2015 and December 31, 2014.

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

|                    | June 30, 2015  |             |                           |                                      |          |          |                      |
|--------------------|--|-------------|---------------------------|--------------------------------------|----------|----------|----------------------|
|                    | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction/<br>Land<br>Development | Business | Consumer | Total <sup>(1)</sup> |
| Risk Rating:       |  |             |                           |                                      |          |          |                      |
| Pass               | \$248,772  | \$119,394   | \$227,853                 | \$37,559                             | \$6,275  | \$6,790  | \$646,643            |
| Special<br>mention | 6,728  | 1,404       | 12,175                    | —                                    | —        | 188      | 20,495               |
| Substandard        | 2,310  | 1,683       | 1,222                     | —                                    | —        | 73       | 5,288                |
| Total loans        | \$257,810  | \$122,481   | \$241,250                 | \$37,559                             | \$6,275  | \$7,051  | \$672,426            |

<sup>(1)</sup> Net of LIP.

|                 | December 31, 2014                                      |             |                           |                                       |          |          |                      |
|-----------------|--|-------------|---------------------------|---------------------------------------|----------|----------|----------------------|
|                 | One-to-Four<br>Family<br>Residential<br>(In thousands) | Multifamily | Commercial<br>Real Estate | Construction /<br>Land<br>Development | Business | Consumer | Total <sup>(1)</sup> |
| Risk Rating:    |  |             |                           |                                       |          |          |                      |
| Pass            | \$263,094  | \$116,891   | \$235,841                 | \$24,316                              | \$3,783  | \$6,833  | \$650,758            |
| Special mention | 4,157  | 1,416       | 10,529                    | —                                     | —        | —        | 16,102               |
| Substandard     | 6,314  | 1,964       | 1,598                     | —                                     | —        | 297      | 10,173               |
| Total loans     | \$273,565  | \$120,271   | \$247,968                 | \$24,316                              | \$3,783  | \$7,130  | \$677,033            |

<sup>(1)</sup> Net of LIP.

Note 6 - Other Real Estate Owned

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

|                                  | Three Months Ended June 30, |          | Six Months Ended June 30, |          |
|----------------------------------|-----------------------------|----------|---------------------------|----------|
|                                  | 2015                        | 2014     | 2015                      | 2014     |
|                                  | (In thousands)              |          |                           |          |
| Balance at beginning of period   | \$5,575                     | \$11,609 | \$9,283                   | \$11,465 |
| Loans transferred to OREO        | —                           | 439      | 141                       | 1,630    |
| Capitalized improvements         | —                           | 52       | —                         | 52       |
| Gross proceeds from sale of OREO | (1,207                      | ) (1,858 | ) (5,535                  | ) (2,638 |
| Gain (loss) on sale of OREO      | 2                           | (36      | ) 531                     | (107     |
| Market value adjustments         | 46                          | (92      | ) (4                      | ) (288   |
| Balance at end of period         | \$4,416                     | \$10,114 | \$4,416                   | \$10,114 |

We sold \$1.2 million of OREO during the second quarter of 2015, which was comprised of four properties and one lot of a fifth property, recognizing a net gain of \$2,000. OREO includes properties acquired by the Company through foreclosure and deed in lieu of foreclosure. OREO at June 30, 2015 consisted of \$4.1 million in commercial real estate properties, and \$355,000 in construction and land development projects.



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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:

Fair Value Measurements at June 30, 2015

|                                    | Fair Value<br>Measurements | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|------------------------------------|----------------------------|---|---|---|
|                                    | (In thousands)             |   |   |   |
| Investments<br>available-for-sale: |                            |   |   |   |
| Mortgage-backed<br>investments:    |                            |   |   |   |
| Fannie Mae                         | \$38,975                   | \$—   | \$38,975  | \$—   |
| Freddie Mac                        | 23,348                     | —   | 23,348  | —   |
| Ginnie Mae                         | 22,758                     | —   | 22,758  | —   |
| Municipal bonds                    | 3,484                      | —   | 3,484   | —   |
| U.S. Government agencies           | 14,315                     | —   | 14,315  | —   |
| Corporate bonds                    | 14,033                     | —   | 14,033  | —   |
| Total                              | \$116,913                  | \$—   | \$116,913   | \$—   |



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## Fair Value Measurements at December 31, 2014

|                                    | Fair Value<br>Measurements | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|------------------------------------|----------------------------|---|---|---|
|                                    | (In thousands)             |   |   |   |
| Investments<br>available-for-sale: |                            |   |   |   |
| Mortgage-backed<br>investments:    |                            |   |   |   |
| Fannie Mae                         | \$40,916                   | \$—   | \$40,916  | \$—   |
| Freddie Mac                        | 21,946                     | —   | 21,946  | —   |
| Ginnie Mae                         | 26,013                     | —   | 26,013  | —   |
| Municipal bonds                    | 644                        | —   | 644   | —   |
| U.S. Government agencies           | 16,816                     | —   | 16,816  | —   |
| Corporate bonds                    | 14,039                     | —   | 14,039  | —   |
| Total                              | \$120,374                  | \$—   | \$120,374   | \$—   |

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 June 30, 2015 and December 31, 2014.

## Fair Value Measurements at June 30, 2015

|  | Fair Value<br>Measurements | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets (Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|----------------------------|---|--|--|
|  | (In thousands)             |   |  |  |
| Impaired loans (included in loans<br>receivable, net) <sup>(1)</sup> | \$49,287                   | \$—   | \$—  | \$49,287   |
| OREO   | 4,416                      | —   | —  | 4,416  |
| Total  | \$53,703                   | \$—   | \$—  | \$53,703   |

<sup>(1)</sup> Total fair value of impaired loans is net of \$811,000 of specific reserves on performing TDRs.

## Fair Value Measurements at December 31, 2014

|  | Fair Value<br>Measurements | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets (Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|----------------------------|---|--|--|
|  | (In thousands)             |   |  |  |
| Impaired loans (included in loans<br>receivable, net) <sup>(1)</sup> | \$54,444                   | \$—   | \$—  | \$54,444   |

|       |          |     |     |          |
|-------|----------|-----|-----|----------|
| OREO  | 9,283    | —   | —   | 9,283    |
| Total | \$63,727 | \$— | \$— | \$63,727 |

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(1) Total fair value of impaired loans is net of \$1.2 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

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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 June 30, 2015 and December 31, 2014.

| June 30, 2015     |                                      |                        |   |                             |
|-------------------|--------------------------------------|------------------------|---|-----------------------------|
|                   | Fair Value<br>(Dollars in thousands) | Valuation<br>Technique | Unobservable Input(s)                                       | Range (Weighted<br>Average) |
| Impaired Loans    | \$49,287                             | Market approach        | Appraised value discounted by market or borrower conditions | 0.0% - 11.1%<br>(0.0%)      |
| OREO              | \$4,416                              | Market approach        | Appraised value less selling costs                          | 0.0% - 0.0% (0.0%)          |
| December 31, 2014 |                                      |                        |   |                             |
|                   | Fair Value<br>(Dollars in thousands) | Valuation<br>Technique | Unobservable Input(s)                                       | Range (Weighted<br>Average) |
| Impaired Loans    | \$54,365                             | Market approach        | Appraised value discounted by market or borrower conditions | 0% - 45.8%<br>(2.2%)        |
| OREO              | \$9,283                              | Market approach        | Appraised value less selling costs                          | 0% - 19.4%<br>(3.3%)        |

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

| June 30, 2015                     |                                  |                         |                                |         |         |
|-----------------------------------|----------------------------------|-------------------------|--------------------------------|---------|---------|
|                                   | Carrying Value<br>(In thousands) | Estimated<br>Fair Value | Fair Value Measurements Using: |         |         |
|                                   |                                  |                         | Level 1                        | Level 2 | Level 3 |
| <b>Financial Assets:</b>          |                                  |                         |                                |         |         |
| Cash on hand and in banks         | \$5,550                          | \$5,550                 | \$5,550                        | \$—     | \$—     |
| Interest-earning deposits         | 101,424                          | 101,424                 | 101,424                        | —       | —       |
| Investments available-for-sale    | 116,913                          | 116,913                 | —                              | 116,913 | —       |
| Loans receivable, net             | 659,273                          | 672,499                 | —                              | —       | 672,499 |
| FHLB stock                        | 6,537                            | 6,537                   | —                              | 6,537   | —       |
| Accrued interest receivable       | 3,033                            | 3,033                   | —                              | 3,033   | —       |
| <b>Financial Liabilities:</b>     |                                  |                         |                                |         |         |
| Deposits                          | 222,216                          | 222,216                 | 222,216                        | —       | —       |
| Certificates of deposit, retail   | 335,370                          | 336,689                 | —                              | 336,689 | —       |
| Certificates of deposit, brokered | 66,122                           | 66,635                  | —                              | 66,635  | —       |

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|                          |         |         |   |         |   |
|--------------------------|---------|---------|---|---------|---|
| Advances from the FHLB   | 135,500 | 135,762 | — | 135,762 | — |
| Accrued interest payable | 145     | 145     | — | 145     | — |

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|                                   | December 31, 2014                |                         | Fair Value Measurements Using: |         |         |
|-----------------------------------|----------------------------------|-------------------------|--------------------------------|---------|---------|
|                                   | Carrying Value<br>(In thousands) | Estimated<br>Fair Value | Level 1                        | Level 2 | Level 3 |
| <b>Financial Assets:</b>          |                                  |                         |                                |         |         |
| Cash on hand and in banks         | \$ 5,920                         | \$ 5,920                | \$ 5,920                       | \$—     | \$—     |
| Interest-earning deposits         | 98,129                           | 98,129                  | 98,129                         | —       | —       |
| Investments available-for-sale    | 120,374                          | 120,374                 | —                              | 120,374 | —       |
| Loans receivable, net             | 663,938                          | 678,676                 | —                              | —       | 678,676 |
| FHLB stock                        | 6,745                            | 6,745                   | —                              | 6,745   | —       |
| Accrued interest receivable       | 3,265                            | 3,265                   | —                              | 3,265   | —       |
| <b>Financial Liabilities:</b>     |                                  |                         |                                |         |         |
| Deposits                          | 201,539                          | 201,539                 | 201,539                        | —       | —       |
| Certificates of deposit, retail   | 358,159                          | 359,049                 | —                              | 359,049 | —       |
| Certificates of deposit, brokered | 54,429                           | 55,229                  | —                              | 55,229  | —       |
| Advances from the FHLB            | 135,500                          | 135,392                 | —                              | 135,392 | —       |
| Accrued interest payable          | 142                              | 142                     | —                              | 142     | —       |

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.

**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.



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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 - 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.

For the three months ended June 30, 2015 and 2014, total compensation expense for the Plan was \$110,000 and \$87,000, respectively, and the related income tax benefit was \$39,000 and \$30,000, respectively.

For the six months ended June 30, 2015 and 2014, total compensation expense for the Plan was \$219,000 and \$172,000, respectively, and the related income tax benefit was \$77,000 and \$60,000, respectively.

#### 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 June 30, 2015, remaining options for 651,756 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 six months ended June 30, 2015, follows:

|                              | For the three months ended June 30, 2015 |   |                                 |  |
|------------------------------|--|---|---------------------------------|--|
| Shares                       | Weighted-Average<br>Exercise Price       | Weighted-Average<br>Remaining<br>Contractual Term<br>in Years | Aggregate<br>Intrinsic<br>Value |  |
| Outstanding at April 1, 2015 | 899,260                                  | \$ 9.55   |                                 |  |
| Granted                      | —  |   |                                 |  |

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|  |         |      |      |           |
|--|---------|------|------|-----------|
| Exercised  | —       |      |      |           |
| Forfeited or expired   | —       |      |      |           |
| Outstanding at June 30, 2015   | 899,260 | 9.55 | 5.01 | 2,615,817 |
| Vested and expecting to vest assuming a 3%<br>forfeiture rate<br>over the vesting term | 891,370 | 9.54 | 4.98 | 2,598,500 |
| Exercisable at June 30, 2015   | 636,260 | 9.26 | 3.61 | 2,038,577 |

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
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 (Unaudited)

|  | For the six months ended June 30, 2015 |                                    |   | Aggregate<br>Intrinsic<br>Value |
|--|--|------------------------------------|---|---------------------------------|
|  | Shares                                 | Weighted-Average<br>Exercise Price | Weighted-Average<br>Remaining<br>Contractual Term<br>in Years |                                 |
| Outstanding at January 1, 2015   | 929,260                                | \$ 9.51                            |   |                                 |
| Granted  | 20,000                                 | 12.05                              |   | —                               |
| Exercised  | (50,000                                | ) 9.78                             |   | 112,680                         |
| Forfeited or expired   | —                                      |                                    |   | —                               |
| Outstanding at June 30, 2015   | 899,260                                | 9.55                               | 5.01  | 2,615,817                       |
| Vested and expecting to vest assuming a 3%<br>forfeiture rate<br>over the vesting term | 891,370                                | 9.54                               | 4.98  | 2,598,500                       |
| Exercisable at June 30, 2015   | 636,260                                | 9.26                               | 3.61  | 2,038,577                       |

As of June 30, 2015, there was \$765,000 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 3.55 years.

#### 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 June 30, 2015, remaining restricted stock awards for 74,478 shares were available to be awarded. Shares that have been awarded but have not yet vested are held in a reserve account until they are vested.

A summary of changes in nonvested restricted stock awards for the three and six months ended June 30, 2015, follows:

|  | For the three months ended<br>June 30, 2015 |  |
|--|---|--|
|  | Shares                                      | Weighted-Average<br>Grant Date<br>Fair Value |
| Nonvested at April 1, 2015   | 75,600                                      | \$ 8.47                                      |
| Granted  | —   |  |
| Vested   | (6,400                                      | ) 4.03                                       |
| Forfeited  | —   |  |
| Nonvested at June 30, 2015   | 69,200                                      | 8.88   |
| Expected to vest assuming a 3% forfeiture rate over the vesting term | 67,124                                      |  |



FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
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|  | For the six months ended<br>June 30, 2015 |  |
|--|---|--|
|  | Shares                                    | Weighted-Average<br>Grant Date<br>Fair Value |
| Nonvested at January 1, 2014   | 75,600                                    | \$ 8.47                                      |
| Granted  | —   |  |
| Vested   | (6,400                                    | ) 4.03                                       |
| Forfeited  | —   | 0.00   |
| Nonvested at June 30, 2015   | 69,200                                    | 8.88   |
| Expected to vest assuming a 3% forfeiture rate over the vesting term | 67,124                                    |  |

As of June 30, 2015, there was \$449,000 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 2.53 years.

#### Note 9 - 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. At June 30, 2015, the balance of the deferred tax valuation allowance was \$450,000 as a result of a past net capital loss on securities.

Our effective tax rate for the first six months of 2015 was 34.08% partially as a result of permanent tax exclusions of the cash surrender value of BOLI and equity compensation.

The Company has prepared federal tax returns through December 31, 2014, at which time the net operating loss carryforward and capital loss carryforward was \$8.7 million and will begin to expire in 2030. The Company has an alternative minimum tax credit carryforward totaling \$2.1 million which has no expiration date.

#### Note 10 - 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.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES  
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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 June 30,               |            | Six Months Ended June 30, |            |
|--|---|------------|---------------------------|------------|
|  | 2015                                      | 2014       | 2015                      | 2014       |
|  | (Dollars in thousands, except share data) |            |                           |            |
| Net income   | \$2,368                                   | \$2,367    | \$4,597                   | \$5,012    |
| Less: Earnings allocated to participating securities | (11                                       | ) (14      | ) \$(21                   | ) \$(30    |
| Earnings allocated to common shareholders            | \$2,357                                   | \$2,353    | \$4,576                   | \$4,982    |
| Basic weighted average common shares outstanding     | 13,756,336                                | 15,042,712 | 13,895,872                | 15,146,999 |
| Dilutive stock options                               | 133,487                                   | 56,546     | 136,596                   | 56,392     |
| Dilutive restricted stock grants                     | 26,491                                    | 21,680     | 24,730                    | 20,764     |
| Diluted weighted average common shares outstanding   | 13,916,314                                | 15,120,938 | 14,057,198                | 15,224,155 |
| Basic earnings per share                             | \$0.17                                    | \$0.16     | \$0.33                    | \$0.33     |
| Diluted earnings per share                           | \$0.17                                    | \$0.16     | \$0.33                    | \$0.33     |

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. Options to purchase an additional 225,000 and 210,000 shares of common stock were not included in the computation of diluted earnings per share for the three and six months ended June 30, 2015 and 2014, respectively, because the incremental shares under the treasury stock method of calculation resulted in them being antidilutive.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Forward-Looking Statements

Certain matters discussed in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” or similar or future or conditional verbs such as “may,” “will,” “should,” “would” and “could.” Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs, that may be affected by deterioration in the housing and commercial real estate markets, and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in

general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve Bank of San Francisco and our bank subsidiary by the Federal Deposit Insurance Corporation (“FDIC”), the Washington State Department of Financial Institutions, Division of Banks (“DFI”) or other regulatory authorities, including the possibility that any such regulatory authority may initiate an enforcement action against the Company or the Bank which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements or restrictions on us, any of which could adversely affect our liquidity and earnings; our ability to pay dividends on our common stock; our ability

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to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining the fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") and the implementing regulations; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our filings with the U.S. Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended December 31, 2014 ("2014 Form 10-K"). Any of the forward-looking statements that we make in this Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

## Overview

First Savings Bank is a wholly-owned subsidiary of First Financial Northwest and, as such, comprises substantially all of the activity for First Financial Northwest. First Savings Bank has historically been a community-based savings bank primarily serving King and to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington, through our full-service banking office located in Renton, Washington. On August 24, 2015, the Bank's name will officially change to First Financial Northwest Bank as a reflection of our broader range of services and expansion of our market area. In addition to our upcoming name change, the Bank has received regulatory approval to open a second branch, which is scheduled to open in the third quarter of 2015 in Mill Creek, Washington.

The Bank is converting to a new core data processor, with an expected completion date in third quarter of 2015. The capitalized cost of the new processor is expected to be \$525,000 and will be amortized over five years. As of June 30, 2015, we have capitalized \$447,000 towards the total cost of the new system. The improved technology that will come with the conversion will assist our growth efforts into additional markets.

First Savings Bank's business consists predominantly of attracting deposits from the general public, combined with borrowing from the Federal Home Loan Bank of Des Moines and raising funds in the wholesale market, and utilizing these funds to originate one-to-four family residential, multifamily, commercial real estate, construction/land development, business, and consumer loans. Our current business strategy emphasizes commercial real estate, construction, one-to-four family residential, and multifamily lending.

Our primary source of revenue is interest income, which is the income that we earn on our loans and investments. Interest expense is the interest that we pay on our deposits and borrowings. Net interest income is the difference between interest income and interest expense. Changes in levels of interest rates affect interest income and interest expense differently and, thus, our net interest income.

An offset to net interest income is the provision for loan losses which is required to establish the allowance for loan and lease losses ("ALLL") at a level that adequately provides for probable losses inherent in our loan portfolio. As a loan's risk rating improves, property values increase, or recoveries of amounts previously charged off are received, a recapture of previously recognized provision for loan losses may be added to net interest income.

Our noninterest expenses consist primarily of salaries and employee benefits, OREO-related expenses, professional fees, regulatory assessments, occupancy and equipment, and other general and administrative expenses. Salaries and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement, and other employee benefits. OREO-related expenses consist primarily of maintenance and costs of utilities for the OREO inventory, market valuation adjustments, build-out expenses, gains and losses from OREO sales, legal fees, real estate taxes, and insurance related to the properties included in the OREO inventory. Professional fees include legal services, auditing and accounting services, computer support services, and other professional services in support of strategic plans. Occupancy and equipment expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of real estate taxes, depreciation expenses, maintenance, and costs of utilities.

### Critical Accounting Policies

Our significant accounting policies are fundamental to understanding our results of operations and financial condition because they require that we use estimates and assumptions that may affect the value of our assets or liabilities and our financial results. These policies are critical because they require management to make difficult, subjective, and complex judgments about matters that are inherently uncertain and because it is likely that materially different amounts would be reported under different conditions or by using different assumptions. These policies govern the allowance for loan and lease losses ("ALLL"), the valuation of OREO, and the calculation of deferred taxes, fair values, and other-than-temporary impairments on the market value of investments. These policies and estimates are described in further detail in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies with the 2014 Form 10-K. There have not been any material changes in the Company's critical accounting policies and estimates as compared to the disclosure contained in the 2014 Form 10-K.

### Comparison of Financial Condition at June 30, 2015 and December 31, 2014

Total assets were \$944.4 million at June 30, 2015, an increase of 0.8%, from \$937.0 million at December 31, 2014. The following table details the \$7.4 million net change in the composition of our assets at June 30, 2015 from December 31, 2014.

|   | Balance at<br>June 30, 2015 | Change from<br>December 31, 2014 | Percent Change |    |
|---|-----------------------------|----------------------------------|----------------|----|
| (Dollars in thousands)                        |                             |                                  |                |    |
| Cash on hand and in banks                     | \$5,550                     | \$(370)                          | (6.3)          | )% |
| Interest-earning deposits                     | 101,424                     | 3,295                            | 3.4            | )  |
| Investments available-for-sale, at fair value | 116,913                     | (3,461)                          | (2.9)          | )  |
| Loans receivable, net                         | 659,273                     | (4,665)                          | (0.7)          | )  |
| Premises and equipment, net                   | 16,934                      | 200                              | 1.2            | )  |
| FHLB stock, at cost                           | 6,537                       | (208)                            | (3.1)          | )  |
| Accrued interest receivable                   | 3,033                       | (232)                            | (7.1)          | )  |
| Deferred tax assets, net                      | 6,195                       | (2,143)                          | (25.7)         | )  |
| OREO  | 4,416                       | (4,867)                          | (52.4)         | )  |
| Other receivable                              | 2                           | (126)                            | (98.4)         | )  |
| BOLI  | 22,932                      | 20,156                           | 726.1          | )  |
| Prepaid expenses and other assets             | 1,223                       | (144)                            | (10.5)         | )  |
| Total assets                                  | \$944,432                   | \$7,435                          | 0.8            | %  |

Interest-earning deposits. Our interest-earning deposits, consisting primarily of funds held at the Federal Reserve Bank, increased \$3.3 million at June 30, 2015, as compared to December 31, 2014. The primary sources of cash were \$9.0 million from operations, \$9.6 million from increased deposits, and \$5.5 million of proceeds from the sale of

OREO properties. Offsetting these inflows, the most significant use of cash for the quarter was the purchase of \$20.0 million in BOLI policies.

Investments available-for-sale. Our investment portfolio decreased by \$3.5 million during the first six months of 2015. During this time, eight fixed rate securities were purchased for a total of \$8.5 million, which include five tax-exempt municipal bonds and three mortgage-backed securities with a combined expected yield of 2.44%. Included in these purchases

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was a \$578,000 tax-exempt municipal bond that settled on July 2, 2015, resulting in an investment trade payable reported as of June 30, 2015. Principal paydowns of \$9.6 million and calls of \$1.6 million of taxable municipal and U.S. Government agency bonds were received during the first six months of 2015. The fair market value of our portfolio had a pre-tax decrease of \$270,000 during the first six months of 2015.

The effective duration of the investment portfolio at June 30, 2015, was 2.8% as compared to 2.4% at December 31, 2014. Effective duration is a measure that attempts to quantify the anticipated percentage change in the value of an investment (or portfolio) in the event of a 100 basis point change in market yields. Since the Bank's portfolio includes securities with embedded options (including call options on bonds and prepayment options on mortgage-backed securities), management believes that effective duration is an appropriate metric to use as a tool when analyzing the Bank's investment securities portfolio, as effective duration incorporates assumptions relating to such embedded options, including changes in cash flow assumptions as interest rates change.

Loans receivable. Net loans receivable decreased \$4.7 million to \$659.3 million at June 30, 2015 compared to December 31, 2014. One-to-four family residential loan decreased \$15.9 million during the first six months of 2015 as the continued low interest rate environment has significantly increased competition in the market. In addition, a \$7.0 million decrease in commercial real estate loans was offset by increases of \$11.1 million in construction and land development loans, \$2.6 million of multifamily real estate loans and \$2.5 million in business loans.

Of the increase in construction and land development loans, \$10.6 million was for one-to-four family loans, predominantly related to "in-fill" speculative construction projects in selective urban areas that have high levels of nearby amenities. At June 30, 2015, we had \$25.2 million outstanding in committed but undisbursed funds for construction loans, a \$2.2 million decrease from December 31, 2014.

Our five largest borrowing relationships, representing 11.3% of our net loans increased \$2.0 million from December 31, 2014 to June 30, 2015; however, the number of loans represented by these borrowers has decreased from 97 at December 31, 2014 to 71 at June 30, 2015. At June 30, 2015 all five borrowers were current on their loan payments. We monitor the performance of these borrowing relationships very closely due to the concentration risk they possess in relation to the entire loan portfolio. The following table details our five largest lending relationships at June 30, 2015:

| Borrower <sup>(1)</sup> | Number of Loans | One-to-Four Family Residential <sup>(2)</sup><br>(Dollars in thousands) | Multifamily | Commercial Real Estate <sup>(2)</sup> | Construction/Land Development | Aggregate Balance of Loans <sup>(3)</sup> |
|-------------------------|-----------------|---|-------------|---------------------------------------|-------------------------------|---|
| Real estate investor    | 3               | \$—   | \$—         | \$ 17,964                             | \$—                           | \$ 17,964                                 |
| Real estate investor    | 4               | 483   | —           | 15,442                                | —                             | 15,925                                    |
| Real estate investor    | 2               | —   | —           | 14,672                                | —                             | 14,672                                    |
| Real estate builder     | 55              | 12,992  | —           | —                                     | 1,156                         | 14,148                                    |
| Real estate investor    | 7               | —   | 13,489      | —                                     | —                             | 13,489                                    |
| Total                   | 71              | \$ 13,475   | \$ 13,489   | \$ 48,078                             | \$ 1,156                      | \$ 76,198                                 |

<sup>(1)</sup> The composition of borrowers represented in the table may change between periods.

<sup>(2)</sup> One-to-four family residential includes \$483,000 of owner occupied and \$13.0 million of non-owner occupied. Commercial real estate loans for these borrowers are for non-owner occupied properties.

<sup>(3)</sup> Net of LIP.

The ALLL increased \$112,000 to \$10.6 million at June 30, 2015, as compared to \$10.5 million at December 31, 2014 and represented 1.6% of total loans receivable at both June 30, 2015 and December 31, 2014. We believe that the ALLL at June 30, 2015 was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date.

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will be proven correct in the future, that the actual amount of future losses will not exceed the amount of past provisions, or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. Future additions to the allowance may become necessary based upon changing economic conditions, the level of problem loans, business conditions, credit concentrations, increased loan balances, or changes in the underlying collateral of the loan portfolio. In addition, the determination of the amount of our ALLL is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional loss reserves or

the charge-off of specific loans against established loss reserves based upon their judgment of information available to them at the time of their examination.

As we work with our borrowers that face difficult financial circumstances, we explore various options available to minimize our risk of loss. At times, the best option for our customers and the Bank is to modify the loan for a period of time, usually one year or less. These modifications have included a reduction in interest rate on the loan for a period of time, advancing the maturity date of the loan, or allowing interest only payments for a specific time frame. These modifications are granted only when there is a reasonable and attainable restructured loan plan that has been agreed to by the borrower and is considered to be in the Bank's best interest.

The following table presents a breakdown of our TDRs at the dates indicated:

|                                 | June 30, 2015  | December 31,<br>2014 | June 30, 2014 | Six Month<br>Change | One Year<br>Change |
|---------------------------------|----------------|----------------------|---------------|---------------------|--------------------|
|                                 | (In thousands) |                      |               |                     |                    |
| Nonperforming TDRs:             |                |                      |               |                     |                    |
| One-to-four family residential  | \$—            | \$—                  | \$458         | \$—                 | \$(458)            |
| Total nonperforming TDRs        | —              | —                    | 458           | —                   | (458)              |
| Performing TDRs:                |                |                      |               |                     |                    |
| One-to-four family residential  | 38,189         | 42,908               | 45,366        | (4,719)             | (7,177)            |
| Multifamily                     | 1,609          | 2,172                | 2,192         | (563)               | (583)              |
| Commercial real estate          | 7,765          | 9,118                | 9,182         | (1,353)             | (1,417)            |
| Consumer                        | 43             | 43                   | 43            | —                   | —                  |
| Total performing TDRs           | 47,606         | 54,241               | 56,783        | (6,635)             | (9,177)            |
| Total TDRs                      | \$47,606       | \$54,241             | \$57,241      | \$(6,635)           | \$(9,635)          |
| % TDRs classified as performing | 100.0          | % 100.0              | % 99.2        | %                   |                    |

Our TDRs decreased \$6.6 million at June 30, 2015 compared to December 31, 2014 as paydowns continue to outpace the addition of TDRs to our portfolio. During the first six months of 2015, \$5.3 million of TDR loans were paid off. At June 30, 2015, all TDRs were performing according to their restructured payment terms and there were no committed but undisbursed funds in connection with our restructured and impaired loans. The largest TDR relationship at June 30, 2015, totaled \$12.0 million and was comprised of \$11.3 million in one-to-four family residential rental properties and \$776,000 in owner occupied commercial property, all located in King County.

Nonperforming assets decreased to \$6.8 million at June 30, 2015, compared to \$10.6 million at December 31, 2014. The following table presents a breakdown of our nonperforming assets and as a percent of total assets at the dates indicated:

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|  | June 30,<br>2015<br>(In thousands) | December 31,<br>2014 | June 30,<br>2014 | Six Month<br>Change | One Year<br>Change |
|--|------------------------------------|----------------------|------------------|---------------------|--------------------|
| Nonperforming loans:                                 |                                    |                      |                  |                     |                    |
| One-to-four family residential                       | \$ 252                             | \$ 830               | \$ 1,380         | \$(578 )            | \$(1,128 )         |
| Multifamily  | 1,683                              | —                    | 222              | 1,683               | 1,461              |
| Commercial real estate                               | 407                                | 434                  | 701              | (27 )               | (294 )             |
| Consumer   | 73                                 | 75                   | —                | (2 )                | 73                 |
| Total nonperforming loans                            | 2,415                              | 1,339                | 2,303            | 1,076               | 112                |
| OREO   | 4,416                              | 9,283                | 10,114           | (4,867 )            | (5,698 )           |
| Total nonperforming assets <sup>(1)</sup>            | \$ 6,831                           | \$ 10,622            | \$ 12,417        | \$(3,791 )          | \$(5,586 )         |
| Nonperforming assets as a<br>percent of total assets | 0.72%                              | 1.13%                | 1.38%            |                     |                    |

<sup>(1)</sup> The difference between the \$6.8 million of nonperforming assets at June 30, 2015, reported above, and the totals reported by other industry sources as our nonperforming assets is due to the inclusion of all TDRs, whether classified as performing or nonperforming loans, as nonperforming loans. All of our TDRs were performing in accordance with their restructured terms at June 30, 2015.

Nonaccrual loans are loans that are 90 days or more delinquent or other loans which, in management's opinion, the borrower is unable to meet scheduled payment obligations. Nonaccrual loans increased \$1.1 million to \$2.4 million at June 30, 2015, from \$1.3 million at December 31, 2014. This increase was the result of a \$2.0 million loan transferred to nonaccrual offset by \$318,000 in net charge-offs, \$419,000 in short sales, and \$164,000 of loans transferred to OREO, net of charge-offs.

The three largest nonaccrual loans in the loan portfolio at June 30, 2015, included a \$1.7 million multifamily loan secured by a 44-unit apartment complex in Pierce County; a \$313,000 commercial loan in Pierce County secured by a six-unit rental vacation lodge; and a one-to-four family loan with an outstanding balance of \$176,000, secured by an owner occupied single family residence in King County.

We continue to focus our efforts on converting nonaccrual loans to OREO and subsequently selling the properties. By taking ownership of these properties, we can generally convert nonearning assets into earning assets on a more timely basis. Our success in this area is reflected by the improved ratio of our nonperforming assets as a percent of total assets of 0.72% at June 30, 2015, compared to 1.13% at December 31, 2014.

OREO. OREO includes properties acquired by the Bank through foreclosure or deed in lieu of foreclosure. At June 30, 2015, OREO was \$4.4 million, a decrease of \$4.9 million from \$9.3 million at December 31, 2014. During the first six months of 2015, we transferred one property into OREO at \$141,000 and sold seven properties for \$5.0 million, generating a net gain on sale of \$531,000.

The three largest OREO properties at June 30, 2015 were an office and retail building valued at \$837,000 located in Pierce County, a land development project approved for 105 one-to-four family residential lots valued at \$754,000 located in Kitsap County, and a multi-tenant retail building valued at \$728,000 located in Pierce County.

The following table presents a breakdown of our OREO by county and number of properties at June 30, 2015:





|                                       | County                 |        |              | Total<br>OREO | Number of<br>Properties | Percent of<br>Total OREO |   |
|---------------------------------------|------------------------|--------|--------------|---------------|-------------------------|--------------------------|---|
|                                       | Pierce                 | Kitsap | All<br>Other |               |                         |                          |   |
|                                       | (Dollars in thousands) |        |              |               |                         |                          |   |
| OREO:                                 |                        |        |              |               |                         |                          |   |
| One-to-four family residential        | \$—                    | \$—    | \$—          | \$—           | —                       | —                        | % |
| Commercial real estate <sup>(1)</sup> | 2,430                  | 754    | 877          | 4,061         | 8                       | 92.0                     |   |
| Construction/land development         | 200                    | —      | 155          | 355           | 2                       | 8.0                      |   |
| Total OREO                            | \$2,630                | \$754  | \$1,032      | \$4,416       | 10                      | 100.0                    | % |

<sup>(1)</sup> Of the eight properties classified as commercial real estate, five are office/retail buildings and three are undeveloped lots.

Deposits. During the first six months of 2015, deposits increased \$9.6 million to \$623.7 million at June 30, 2015, compared to \$614.1 million at December 31, 2014. Deposit accounts consisted of the following:

|                                   | June 30, 2015          | Change from<br>December 31, 2014 | Percent Change |   |
|-----------------------------------|------------------------|----------------------------------|----------------|---|
|                                   | (Dollars in thousands) |                                  |                |   |
| Noninterest-bearing NOW           | \$20,531               | \$6,177                          | 43.0           | % |
| Statement savings                 | 18,027                 | (2,725)                          | (13.1)         | ) |
| Money market                      | 25,962                 | 2,061                            | 8.6            |   |
| Certificates of deposit, retail   | 157,696                | 15,164                           | 10.6           |   |
| Certificates of deposit, brokered | 335,370                | (22,789)                         | (6.4)          | ) |
|                                   | 66,122                 | 11,693                           | 21.5           | % |
|                                   | \$623,708              | \$9,581                          | 1.6            | % |

The increase in total deposits consisted of a \$2.1 million net decrease in retail deposits and an \$11.7 increase in brokered certificates of deposit. Continued growth was experienced in our noninterest-bearing checking and money market accounts in part as a result of our efforts to increase our business customers. Offsetting these increases, retail certificates of deposit decreased by \$22.8 million as maturing certificates did not renew. At June 30, 2015, and December 31, 2014, we held \$16.0 million and \$15.9 million, respectively, in public funds, nearly all of which were retail certificates of deposit. Recently we have been less aggressive in competing for certificates of deposit and public funds in order to reduce our cost of funds.

During the first six months of 2015, our balance of brokered certificates of deposit increased by \$11.7 million, bringing the total balance of brokered funds to \$66.1 million with an average cost of 1.86%. While these funds carry a higher cost than our retail certificates, their maturity periods of four to six years, along with the enhanced call features of these deposits, assist us in our efforts to manage interest rate risk.

Advances. We use advances from the FHLB as an alternative funding source, to reduce interest rate risk, and to leverage our balance sheet. Total FHLB advances at June 30, 2015 and December 31, 2014 were \$135.5 million. Of the total balance, \$64.0 million is due to mature within one year, with the remaining \$71.5 million due in one to five years.

Stockholders' Equity. Total stockholders' equity decreased \$3.8 million during the first six months of 2015 to \$177.6 million at June 30, 2015, from \$181.4 million at December 31, 2014. Retained earnings increased \$2.9 million due to \$4.6 million of net income offset by \$1.7 million of shareholder dividends paid at \$0.12 per share. Additional

paid-in-capital decreased \$7.2 million as a result of \$8.0 million used to repurchase 665,057 shares, partially offset by \$489,000 from the exercise of stock options. Accumulated other comprehensive loss increased to \$533,000 as a result of \$176,000 after-tax unrealized loss on from valuation adjustments on investments available-for-sale.

As part of the strategy to increase shareholder value, the Company has been repurchasing shares at a per share price averaging below book value. As evidence of the success of this plan, year-to-date net income as of June 30, 2015 was \$415,000 lower than for the same period in 2014, with equal earnings per share of \$0.33 for both years. In October 2014, the Company's

board of directors authorized the purchase of an additional 1,546,600 shares of the Company's common stock, or 10% of the shares outstanding. In 2015, 293,300 shares were repurchased under this plan at an average price of \$12.00 per share before this plan expired on April 22, 2015. In April 2015, the board authorized repurchase of an additional 1,492,400 shares between April 28 and October 28, 2015. As of June 30, 2015, the Company had repurchased 371,757 shares under this plan at an average price of \$11.95 per share.

#### Comparison of Operating Results for the Three Months Ended June 30, 2015 and 2014

General. Net income for the three months ended June 30, 2015 and June 30, 2014 was \$2.4 million, or \$0.17 per diluted share for the quarter ended June 30, 2015 as compared to \$0.16 per diluted share for the quarter ended June 30, 2014. A decrease of \$610,000 in net interest income in the second quarter of 2015, as compared to the same period of 2014, was partially offset by a \$400,000 increase in the recapture of provision for loan losses and \$269,000 increase in noninterest income. Noninterest expenses increased by \$172,000 in the second quarter of 2015 as compared to the same period of 2014, resulting in stable net income for the comparative periods.

Net Interest Income. Net interest income for the quarter ended June 30, 2015 decreased \$610,000 to \$7.6 million, as compared to \$8.2 million for the second quarter in 2014. The decrease was a combined result of a decrease in interest income and an increase in interest expense. These changes were primarily due to the shift in our asset mix as a result of a decrease in the average balance of higher yielding assets, consisting of loans receivable and investments available-for-sale, and an increase in the average balance of our low yielding interest-earning deposits.

The following table details the change in net interest income due to changes in yield or cost, or changes in the average balance of the related asset or liability:

|   | Three Months Ended June 30,<br>2015 compared to June 30, 2014 |           |           |
|---|---|-----------|-----------|
|   | Net Change  |           |           |
|   | Rate  | Volume    | Total     |
|   | (In thousands)  |           |           |
| Interest-earning assets:                                    |   |           |           |
| Loan receivable, net  | \$ (306   | ) \$ (123 | ) \$ (429 |
| Investments available-for-sale                              | (12   | ) (78     | ) (90     |
| Interest-earning deposits                                   | (4  | ) 47      | 43        |
| FHLB stock  | 2   | —         | 2         |
| Total net change in income on interest-earning assets       | (320  | ) (154    | ) (474    |
| Interest-bearing liabilities:                               |   |           |           |
| NOW   | —   | (1        | ) (1      |
| Statement savings   | 2   | 1         | 3         |
| Money market  | 43  | 8         | 51        |
| Certificates of deposit, retail                             | (120  | ) (142    | ) (262    |
| Certificates of deposit, brokered                           | —   | 304       | 304       |
| Advances from the FHLB                                      | 18  | 23        | 41        |
| Total net change in expense on interest-bearing liabilities | (57   | ) 193     | 136       |
| Total net change in net interest income                     | \$ (263   | ) \$ (347 | ) \$ (610 |

Loan interest income decreased \$429,000 during the second quarter of 2015 as compared to the same period in 2014 as a result of a \$9.1 million decrease in the average outstanding loan balance combined with a decrease in yield of 17 basis points. Loan originations were outpaced by payoffs on higher yielding loans as the Bank faces significant competition in this prolonged, low interest-rate environment.

Interest income from our investments available-for-sale decreased by \$90,000 during the second quarter of 2015 as compared to the same period in 2014 as our average balance decreased by \$17.7 million, primarily from principal paydowns. Our

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yield had a small decrease of four basis points. We continue to evaluate our investment portfolio and are actively pursuing opportunities to sell lower performing securities for higher performing ones that will assist in managing our interest rate risk.

Further contributing to the decrease in net interest income, interest expense increased by \$136,000 during the second quarter of 2015 as compared to the same period in 2014. Our average balance of interest-bearing liabilities increased \$42.8 million, and our average cost of funds increased three basis points to 0.90% for the three months ended June 30, 2015 as compared to the same period last year. The addition of \$66.1 million of brokered certificates of deposit during the last 12 months at an average cost of 1.84% resulted in \$304,000 of interest expense during the second quarter of 2015. Additional increases in interest expense of \$51,000 and \$41,000 incurred in money market accounts and FHLB advances, respectively, as a combined result of increases in their average balances and respective rates. These increases were partially offset by a decrease in interest of \$262,000 on retail certificates of deposit, due to a decrease in the average balance of \$48.1 million and a decrease in the average rate of 14 basis points, as new and maturing certificates repriced at lower rates.

The following table compares detailed average balances, associated yields and rates, and the resulting changes in interest and dividend income or expense for the three months ended June 30, 2015 and 2014:

|                                    | Three Months Ended June 30, |          | 2014         | Yield or | Change in  |
|------------------------------------|-----------------------------|----------|--------------|----------|------------|
|                                    | 2015                        |          |              |          |            |
|                                    | Average                     | Yield or | Average      | Yield or | Dividends  |
|                                    | Balance                     | Cost     | Balance      | Cost     |            |
|                                    | (Dollars in thousands)      |          |              |          |            |
| Loans receivable, net              | \$ 664,195                  | 5.23     | % \$ 673,339 | 5.40     | % \$(429 ) |
| Investments available-for-sale     | 115,972                     | 1.71     | 133,701      | 1.75     | (90 )      |
| Interest-earning deposits          | 101,373                     | 0.26     | 32,493       | 0.27     | 43         |
| FHLB stock                         | 6,627                       | 0.18     | 6,936        | 0.06     | 2          |
| Total interest-earning assets      | \$ 888,167                  | 4.16     | % \$ 846,469 | 4.58     | % \$(474 ) |
| NOW                                | \$ 18,198                   | 0.11     | % \$ 21,829  | 0.11     | % \$(1 )   |
| Statement savings                  | 25,188                      | 0.14     | 22,465       | 0.11     | 3          |
| Money market                       | 154,066                     | 0.33     | 138,851      | 0.22     | 51         |
| Certificates of deposit, retail    | 340,992                     | 1.04     | 389,059      | 1.18     | (262 )     |
| Certificates of deposit, brokered  | 66,122                      | 1.84     | —            | —        | 304        |
| Advances from the FHLB             | 135,500                     | 0.95     | 125,094      | 0.89     | 41         |
| Total interest-bearing liabilities | \$ 740,066                  | 0.90     | % \$ 697,298 | 0.87     | % \$ 136   |

Interest expense related to our FHLB advances increased \$41,000, primarily due to a \$10.4 million increase in average FHLB advances for the three months ended June 30, 2015, as compared to the same period in 2014. In addition, the average rate paid for these funds increased six basis points to 0.95% for the second quarter of 2015, as compared to 0.89% in the same quarter in 2014. This increase in the average rate paid in the 2015 quarter relates to management's decision to utilize longer term advances from the FHLB, with maturities ranging from four to five years for the advances obtained in 2014, to assist in our interest rate risk management efforts.

Provision for Loan Losses. Management recognizes that loan losses may occur over the life of a loan and that the ALLL must be maintained at a level necessary to absorb specific losses on impaired loans and probable losses inherent in the loan portfolio. Our methodology for analyzing the ALLL consists of two components: general and specific reserves. The general reserve is determined by applying factors to our various groups of loans. Management

considers factors such as charge-off history, the prevailing economy, borrower's ability to repay, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, managements' experience level, our loan review and grading systems, the value of underlying collateral and the level of problem loans in assessing the ALLL. The specific reserve component is created when management believes that the collectability of a specific loan has been impaired and a loss is probable. The specific reserves are computed using current appraisals, listed sales prices, and other available information, less costs to complete, if any, and costs to sell the property. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or if future events differ from current estimates.

During the quarter ended June 30, 2015, management evaluated the adequacy of the ALLL and concluded that a recapture of prior period provisions for loan loss in the amount of \$500,000 was appropriate for the quarter, as compared to a \$100,000 recapture for the second quarter of 2014. For the second quarter of 2015, the recapture was primarily a result of a recovery of \$595,000 on loans previously charged off. The recapture in the second quarter of 2014 was primarily the result of improved property valuations on impaired loans.

The following table summarizes selected financial data related to our ALLL and loan portfolio. All loan balances and ratios are calculated using loan balances that are net of LIP.

|   | At or For the Three Months<br>Ended June 30, |           |   |
|---|--|-----------|---|
|   | 2015   | 2014      |   |
|   | (Dollars in thousands)                       |           |   |
| ALLL balance at beginning of period                         | \$10,508                                     | \$12,093  |   |
| Recapture of provision for loan losses                      | (500   | ) (100    | ) |
| Charge-offs   | —  | (80       | ) |
| Recoveries  | 595  | 38        |   |
| ALLL balance at end of period                               | \$10,603                                     | \$11,951  |   |
| ALLL as a percent of total loans, net of LIP                | 1.58   | % 1.73    | % |
| ALLL as a percent of nonperforming loans, net of LIP        | 439.05                                       | 518.93    |   |
| Total nonperforming loans, net of LIP                       | \$2,415                                      | \$2,303   |   |
| Nonperforming loans as a percent of total loans, net of LIP | 0.36   | % 0.33    | % |
| Total loans receivable, net of LIP                          | \$672,426                                    | \$691,131 |   |
| Total loans originated                                      | 37,547                                       | 41,835    |   |

Noninterest Income. Noninterest income increased \$269,000 to \$357,000 for the quarter ended June 30, 2015, from \$88,000 for the same quarter in 2014. The following table provides a detailed analysis of the changes in the components of noninterest income:

|                                     | Three Months Ended<br>June 30, 2015 | Change from<br>June 30, 2014 | Percent Change |
|-------------------------------------|-------------------------------------|------------------------------|----------------|
|                                     | (Dollars in thousands)              |                              |                |
| Service fees on deposit accounts    | \$29                                | \$6                          | 26.1 %         |
| Loan service fees                   | 37                                  | (10                          | ) (21.3 %)     |
| Gain on sale of investments         | —                                   | 20                           | (100.0 %)      |
| Servicing rights, net               | —                                   | (1                           | ) (100.0 %)    |
| BOLI change in cash surrender value | 136                                 | 136                          | n/a            |
| Other                               | 155                                 | 118                          | 318.9 %        |
| Total noninterest income            | \$357                               | \$269                        | 305.7 %        |

In April 2015, we added \$20.0 million in new BOLI policies bringing our policy total to \$22.9 million. We recognize the increase in cash surrender value of these policies as noninterest income, which assists in offsetting expenses for employee benefits. Prior to the third quarter of 2014, we recognized BOLI income on an annual basis, resulting in \$136,000 in BOLI income recognized during the second quarter of 2015 as compared to none for the same period in 2014.

Other noninterest income increased \$118,000 primarily as a result of a \$95,000 gain on sale of real estate investment property. In addition, we recognized \$22,000 of investment sales commissions generated by referred accounts with a wealth management advisor. This new relationship allows us to offer a broader range of solutions to appropriately meet the needs of our customers.



Noninterest Expense. Noninterest expense increased \$172,000 to \$4.9 million for the second quarter of 2015 from \$4.7 million for the comparable quarter in 2014.

The following table provides a detailed analysis of the changes in the components of noninterest expense:

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|  | Three Months Ended<br>June 30, 2015<br>(Dollars in thousands) | Change from<br>June 30, 2014 | Percent Change |   |
|--|---|------------------------------|----------------|---|
| Salaries and employee benefits             | \$3,251   | \$391                        | 13.7           | % |
| Occupancy and equipment                    | 314   | (18                          | ) (5.4         | ) |
| Professional fees                          | 458   | 64                           | 16.2           |   |
| Data processing                            | 188   | 34                           | 22.1           |   |
| (Gain) Loss on sales of OREO property, net | (2  | ) (38                        | ) (105.6       | ) |
| OREO market value adjustments              | (46   | ) (138                       | ) (150.0       | ) |
| OREO related expenses, net                 | 41  | (37                          | ) (47.4        | ) |
| Regulatory assessments                     | 116   | 12                           | 11.5           |   |
| Insurance and bond premiums                | 89  | (14                          | ) (13.6        | ) |
| Marketing                                  | 54  | 17                           | 46.0           |   |
| Other general and administrative           | 411   | (101                         | ) (19.7        | ) |
| Total noninterest expense                  | \$4,874   | \$172                        | 3.7            | % |

Noninterest expense increased \$172,000 for the second quarter of 2015 as compared to the same period in 2014. The most significant change occurred with a \$391,000 increase in salaries and employee benefits. In preparation for our core processor conversion and expansion of our first branch office, during the last year the number of employees has increased by 12 employees. The individuals staffing these additional positions possess valuable experience and skills that support our strategic plans for future growth.

Partially offsetting the increase, OREO market value adjustments decreased \$138,000, from the second quarter of 2014 to the same period in 2015, as a result of improved values on our OREO properties. In addition, an \$82,000 decrease in our reserve for unfunded loan commitments contributed to improvement in other general and administrative expense.

Federal Income Tax Expense. Our expected effective income tax rate is 35%. We recorded federal income tax provisions of \$1.2 million and \$1.3 million for the quarters ended June 30, 2015, and 2014 as a result of our consolidated net income.

#### Comparison of Operating Results for the Six Months Ended June 30, 2015 and 2014

General. Net income for the six months ended June 30, 2015 was \$4.6 million or \$0.33 per diluted share as compared to net income of \$5.0 million, or \$0.33 per diluted share for the quarter ended June 30, 2014. A decrease in net interest income of \$1.1 million was partially offset by an increase in non-interest income of \$292,000 and a decrease in non-interest expense of \$62,000.

Net Interest Income. Net interest income for the six months ended June 30, 2015 decreased \$1.1 million to \$15.1 million, as compared to \$16.2 million for the same period in 2014. The decrease is a combined result of a decrease in interest income and an increase in interest expense. During the six months ended June 30, 2015, as compared to the same period in 2014, a reduction in the yield on our interest-earning assets was partially offset by an increase in the average balance of these assets of \$43.5 million. The increase in interest expense was primarily a result of an increase in average interest-earning liabilities of \$37.7 million. While the cost of funds remained fairly stable during the comparative periods, rate reductions in our retail certificates of deposit resulted in a significant decrease of interest expense.

The following table details the change in net interest income due to changes in yield or cost, or changes in the average balance of the related asset or liability:

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|   | Six Months Ended June 30,<br>2015 compared to June 30, 2014 |        |        |
|---|---|--------|--------|
|   | Net Change  |        |        |
|   | Rate  | Volume | Total  |
|   | (In thousands)  |        |        |
| Interest-earning assets:                                    |   |        |        |
| Loan receivable, net  | \$(723  | )      | \$(156 |
| Investments available-for-sale                              | (9  | )      | (173   |
| Interest-earning deposits                                   | (2  | )      | 89     |
| FHLB stock  | 2   | —      | 2      |
| Total net change in income on interest-earning assets       | (732  | )      | (240   |
|   |   |        |        |
| Interest-bearing liabilities:                               |   |        |        |
| NOW   | (3  | )      | (2     |
| Statement savings   | 1   | 2      | 3      |
| Money market  | 93  | 11     | 104    |
| Certificates of deposit, retail                             | (326  | )      | (305   |
| Certificates of deposit, brokered                           | —   | 591    | 591    |
| Advances from the FHLB                                      | 50  | 58     | 108    |
| Total net change in expense on interest-bearing liabilities | (185  | )      | 355    |
| Total net change in net interest income                     | \$(547  | )      | \$(595 |

Loan interest income decreased \$879,000 during the first six months of 2015 as compared to the same period in 2014 primarily as a result of a 17 basis points decrease in the average loan yield and, to a lesser extent, a \$5.8 million decrease in the average outstanding loan balance. While payoffs have outpaced originations in one-to-four family, multifamily, and commercial loans, there was an increase in higher yielding construction loans, helping to mitigate some of the decline in interest income.

Interest income from our investments available-for-sale decreased by \$182,000 as our average balance decreased by \$20.1 million from for the first six months of 2015 compared to the same period in 2014. Our yield has remained stable over the past year as several fixed rate securities were purchased with a higher yield than the low yielding, adjustable rate agency securities that were sold in 2013 and 2014.

Further contributing to the decrease in net interest income, interest expense increased by \$170,000 during the first six months of 2015 as compared to the same period in 2014. The addition of \$66.1 million of brokered certificates of deposit during the past year at an average cost of 1.86% resulted in \$591,000 of interest expense for the first six months of 2015. Interest expense on money market accounts and FHLB advances increased by \$104,000 and \$108,000, respectively, during the first six months of 2015 compared to the same period in 2014 as a combined result of rate and volume increases. Retail certificates of deposit continue to decrease, however new certificates are pricing at lower rates, reducing our cost for these funds by 18 basis points for the first six months of 2015 compared to the same period in 2014. Combined with the reduction in the average balance of retail certificates of deposit, our interest expense on these products decreased by \$631,000 for the first six months of 2015 as compared to the same period in 2014.

The following table compares detailed average balances, associated yields and rates, and the resulting changes in interest and dividend income or expense for the six months ended June 30, 2015 and 2014:

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|                                    | Six Months Ended June 30, |          | 2014         | Yield or | Change in    |
|------------------------------------|---------------------------|----------|--------------|----------|--------------|
|                                    | 2015                      |          |              |          |              |
|                                    | Average                   | Yield or | Average      | Yield or | Interest and |
|                                    | Balance                   | Cost     | Balance      | Cost     | Dividends    |
|                                    | (Dollars in thousands)    |          |              |          |              |
| Loans receivable, net              | \$ 666,061                | 5.22     | % \$ 671,834 | 5.39     | % \$(879 )   |
| Investments available-for-sale     | 117,990                   | 1.72     | 138,063      | 1.72     | (182 )       |
| Interest-earning deposits          | 102,366                   | 0.25     | 32,776       | 0.26     | 87           |
| FHLB stock                         | 6,676                     | 0.15     | 6,968        | 0.09     | 2            |
| Total interest-earning assets      | \$ 893,093                | 4.15     | % \$ 849,641 | 4.55     | % \$(972 )   |
| NOW                                | \$ 18,365                 | 0.10     | % \$ 21,919  | 0.13     | % \$(5 )     |
| Statement savings                  | 25,093                    | 0.14     | 22,407       | 0.13     | 3            |
| Money market                       | 149,329                   | 0.33     | 138,508      | 0.2      | 104          |
| Certificates of deposit, retail    | 346,348                   | 1.04     | 396,315      | 1.22     | (631 )       |
| Certificates of deposit, brokered  | 64,242                    | 1.86     | —            | —        | 591          |
| Advances from the FHLB             | 135,500                   | 0.95     | 122,063      | 0.87     | 108          |
| Total interest-bearing liabilities | \$ 738,877                | 0.90     | % \$ 701,212 | 0.89     | % \$ 170     |

Provision for Loan Losses. During the six months ended June 30, 2015 and 2014, management evaluated the adequacy of the ALLL and concluded that a recapture of prior period provisions for loan loss in the amount of \$600,000 was appropriate for the period. The recapture during the first six months of 2015 was primarily a result of recoveries of \$1.1 million, partially offset by charge-offs of \$340,000. For 2014, the first six months recapture was primarily a result of upgrades of risk categories on \$12.3 million of loans and improvements in valuations on our impaired loans.

The following table summarizes selected financial data related to our ALLL and loan portfolio. All loan balances and ratios are calculated using loan balances that are net of LIP.

|  | At or For the Six Months Ended June 30, |            |
|--|---|------------|
|  | 2015                                    | 2014       |
|  | (Dollars in thousands)                  |            |
| ALLL balance at beginning of period                      | \$ 10,491                               | \$ 12,994  |
| (Recapture of provision) provision for loan losses       | (600 )                                  | (600 )     |
| Charge-offs  | (340 )                                  | (633 )     |
| Recoveries   | 1,052                                   | 190        |
| ALLL balance at end of period                            | \$ 10,603                               | \$ 11,951  |
| ALLL as a percent of total loans, net of LIP             | 1.58                                    | % 1.73 %   |
| ALLL as a percent of nonperforming loans, net of LIP     | 439.05                                  | 518.93     |
| Total nonperforming loans, net of LIP                    | \$ 2,415                                | \$ 2,303   |
| Nonperforming loans as a percent of total loans, net LIP | 0.36                                    | % 0.33 %   |
| Total loans receivable, net of LIP                       | \$ 672,426                              | \$ 691,131 |
| Total loans originated                                   | 69,770                                  | 80,719     |

Noninterest Income. Noninterest income increased \$292,000 to \$448,000 for the six months ended June 30, 2015, from \$156,000 for the same period in 2014. The following table provides a detailed analysis of the changes in the components of noninterest income:

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|                                     | Six Months Ended<br>June 30, 2015 | Change from<br>June 30, 2014 | Percent Change |   |
|-------------------------------------|-----------------------------------|------------------------------|----------------|---|
|                                     | (Dollars in thousands)            |                              |                |   |
| Service fees on deposit accounts    | \$43                              | \$10                         | 30.3           | % |
| Loan service fees                   | 56                                | (12)                         | ) (17.7        | ) |
| Loss on sale of investments         | —                                 | 20                           | (100.0         | ) |
| Servicing rights, net               | —                                 | (3)                          | ) (100.0       | ) |
| BOLI change in cash surrender value | 156                               | 156                          | n/a            |   |
| Other                               | 193                               | 121                          | 168.1          |   |
| Total noninterest<br>income         | \$448                             | \$292                        | 187.2          | % |

The \$156,000 increase in noninterest BOLI income was primarily a result of \$20.0 million of BOLI policies added in April 2015. In addition, as discussed above, we changed how we recognized BOLI income, recognizing BOLI income in noninterest income only at year-end until the third quarter of 2014.

Contributing to the \$121,000 increase in other noninterest income, during the first six months of 2015, we sold investment rental property generating a \$95,000 gain. In addition, investment sales commissions of \$23,000 were generated through our new relationship with a wealth management advisor.

Noninterest Expense. Noninterest expense remained stable at \$9.2 million for the six months ending June 30, 2015 and 2014, with only a small decrease of \$62,000 year over year.

The following table provides a detailed analysis of the changes in the components of noninterest expense:

|  | Six Months Ended<br>June 30, 2015 | Change from<br>June 30, 2014 | Percent Change |    |
|--|-----------------------------------|------------------------------|----------------|----|
|  | (Dollars in thousands)            |                              |                |    |
| Salaries and employee benefits         | \$6,665                           | \$920                        | 16.0           | %  |
| Occupancy and<br>equipment             | 652                               | (36)                         | ) (5.2         | )  |
| Professional fees                      | 812                               | 61                           | 8.1            |    |
| Data processing                        | 348                               | 26                           | 8.1            |    |
| Gain on sales of OREO property,<br>net | (531                              | ) (638                       | ) (596.3       | )  |
| OREO market value adjustments          | 4                                 | (284                         | ) (98.6        | )  |
| OREO-related expenses, net             | (7                                | ) (146                       | ) (105.0       | )  |
| Regulatory assessments                 | 232                               | 50                           | 27.5           |    |
| Insurance and bond<br>premiums         | 181                               | (25)                         | ) (12.1        | )  |
| Marketing                              | 87                                | 25                           | 40.3           |    |
| Other general and administrative       | 721                               | (15)                         | ) (2.0         | )  |
| Total noninterest<br>expense           | \$9,164                           | \$(62                        | ) (0.7         | )% |

Salaries and employee benefits expense increased \$920,000 for the first six months of 2015 as compared to the same period in 2014. The number of employees increased by 14 from the beginning of 2014 to June 30, 2015, as we added employees to support our core conversion project and planned branch expansion.

Recoveries of OREO related expenses provided a significant offset to increases in noninterest expenses. Sales of seven OREO properties generated a net gain of \$531,000 for the first six months of 2015, compared to sales of seven

properties for a net loss of \$107,000 for the same period in 2014. In addition, recoveries of valuation adjustments resulted in \$4,000 valuation expense as of June 30, 2015 compared to \$288,000 in valuation expense as of June 30, 2014. Lastly, for the first six months of 2015, OREO rental income exceeded OREO holding costs resulting in a net recovery of \$7,000. For the same period in 2014, OREO holding costs exceeded rental income by \$139,000.



Federal Income Tax Expense. Our expected effective income tax rate is 35%. We recorded federal income tax provisions of \$2.4 million and \$2.8 million for the year-to-date ended June 30, 2015, and 2014 as a result of our consolidated net income.

## Liquidity

We are required to have enough cash flow in order to maintain sufficient liquidity to ensure a safe and sound operation. We maintain cash flows above the minimum level believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. On a daily basis, we review and update cash flow projections to ensure that adequate liquidity is maintained.

Our primary sources of funds are customer deposits, cash flow from the loan and investment portfolios, advances from the FHLB, and to a lesser extent, brokered certificates of deposit. These funds, together with equity, are used to make loans, acquire investment securities and other assets, and fund continuing operations. At June 30, 2015, retail certificates of deposit scheduled to mature in one year or less totaled \$134.4 million. Management's policy is to maintain deposit rates at levels that are competitive with other local financial institutions, although recently we have been less aggressive in competing for certificates of deposit and public funds in order to reduce our cost of funds. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions and competition. We measure our liquidity based on our ability to fund our assets and to meet liability obligations when they come due. Liquidity (and funding) risk occurs when funds cannot be raised at reasonable prices or in a reasonable time frame to meet our normal or unanticipated obligations. We regularly monitor the mix between our assets and our liabilities to manage effectively our liquidity and funding requirements.

When deposits are not readily available and/or cost effective to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to: advances from the FHLB, wholesale funding, brokered deposits, federal funds purchased and dealer repurchase agreements, as well as other short-term alternatives. These funding sources are generally collateral dependent. We may also liquidate assets to meet our funding needs. At June 30, 2015, the Bank maintained credit facilities with the FHLB totaling \$332.1 million with an outstanding balance of \$135.5 million. At June 30, 2015, we also had available a total of \$35.0 million credit facilities with other financial institutions, with no balance outstanding. For additional information, see the Consolidated Statements of Cash Flows in Item 1 of this Form 10-Q.

During the third quarter of 2014, management began utilizing the national brokered deposit market to assist in our funds acquisition and interest rate risk management efforts by adding \$66.1 million of brokered certificates of deposit as of June 30, 2015. In contrast to most retail certificate of deposit offerings which provide the depositor with an option to withdraw their funds prior to maturity, subject to an early withdrawal penalty, certificates of deposit acquired in the brokered market limits the depositor ability to withdraw the funds before the end of the term (except in the case of death or adjudication of incompetence of a depositor) which greatly reduces early redemption risk associated with retail deposits. This strategy may include, but is not necessarily limited to, raising longer term deposits (with terms greater than three years) that assist the Bank in its interest rate risk management efforts. At June 30, 2015, brokered certificates of deposit had a weighted-average maturity of 4.9 years. These certificates also provide the Bank the option to redeem the deposit after six months, a favorable distinction compared to retail certificate of deposit terms that are offered in our local market. With these redemption limitations and call features, the cost of these brokered deposits is generally higher than our retail certificate of deposit offerings. Consequently, as we increase our brokered deposits, our cost of funds may increase.

First Financial Northwest is a separate legal entity from the Bank and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. First Financial Northwest's primary sources of funds

consist of dividends from the Bank, although there are regulatory restrictions on the ability of the Bank to pay dividends. At June 30, 2015, the Company (on an unconsolidated basis) had liquid assets of \$57.8 million.

On a monthly basis, we estimate our liquidity sources and needs for the next six months. Also, we determine funding concentrations and our need for sources of funds other than deposits. This information is used by our Asset/Liability Management Committee ("ALCO") in forecasting funding needs and investing opportunities. We believe that our current liquidity position and our expected operating results are sufficient to fund all of our existing commitments.

#### Commitments and Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and the unused portions of lines of

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credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Commitments to extend credit and lines of credit are not recorded as an asset or liability by us until the instrument is exercised. At June 30, 2015 and December 31, 2014, we had no commitments to originate loans for sale.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of the collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the customer. The amount and type of collateral required varies, but may include real estate and income-producing commercial properties.

The following table summarizes our outstanding commitments to originate loans, to advance additional amounts pursuant to outstanding lines of credit and to disburse funds related to our construction loans at June 30, 2015:

|   | Total Amounts Committed<br>(In thousands) | Amount of Commitment Expiration |                               |                                |                  |
|---|---|---------------------------------|-------------------------------|--------------------------------|------------------|
|   |   | Through One Year                | After One Through Three Years | After Three Through Five Years | After Five Years |
| Commitments to originate loans            | \$13,140                                  | \$13,140                        | \$—                           | \$—                            | \$—              |
| Unused portion of lines of credit         | 7,631                                     | 712                             | 2,421                         | 3,701                          | 797              |
| Undisbursed portion of construction loans | 25,182                                    | 15,733                          | 9,449                         | —                              | —                |
| Total commitments                         | \$45,953                                  | \$29,585                        | \$11,870                      | \$3,701                        | \$797            |

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

We have entered into a five year lease agreement for our new Mill Creek branch location, with three options for three year extensions. Our lease expense is \$50,000 per year, with payments to begin in September 2015.

First Financial Northwest and its subsidiaries from time to time are involved in various claims and legal actions arising in the ordinary course of business. There are currently no matters that in the opinion of management would have a material adverse effect on First Financial Northwest's consolidated financial position, results of operation, or liquidity.

## Capital

At June 30, 2015, stockholders' equity totaled \$177.6 million, or 18.80% of total assets. Our book value per share of common stock was \$12.20 at June 30, 2015 compared to \$11.96 at December 31, 2014. Consistent with our goal to operate a sound and profitable financial organization, we actively seek to maintain a "well-capitalized" status in accordance with regulatory standards. As of June 30, 2015, the Bank exceeded all regulatory capital requirements with a Tier 1 Leverage-Based Capital ratio of 11.70%, a Common Equity Tier 1 (CET1) capital ratio of 17.26%, Tier 1 Risk-Based Capital ratio of 17.26%, and a Total Risk-Based Capital ratio of 18.52%. The CET1 ratio is a new regulatory capital ratio required beginning for the quarter ended March 31, 2015. Under BASEL III, the regulatory capital requirements to be considered well capitalized are 5% for Tier 1 Leverage-Based Capital, 6.5% for CET, 8% for Tier 1 Risk-Based Capital, and 10% for Total Risk-Based Capital.

First Financial Northwest exceeded all regulatory capital requirements with Tier 1 Leverage-Based Capital, CET1, Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios of 18.64%, 27.44%, 27.44%, and 28.69%, respectively, as of June 30, 2015.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

General. Our Board of Directors has approved an asset/liability management policy to guide management in maximizing net interest income by managing the differences in terms between interest-earning assets and interest-bearing liabilities while maintaining acceptable levels of liquidity, capital adequacy, interest rate sensitivity, credit risk, and profitability. The policy established an ALCO, comprised of certain members of senior management and the Board of Directors. The Committee's purpose

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is to manage, coordinate, and communicate our asset/liability position consistent with our business plan and Board-approved policy. The ALCO meets quarterly to review various areas including:

- economic conditions;
- interest rate outlook;
- asset/liability mix;
- interest rate risk sensitivity;
- current market opportunities to promote specific products;
- historical financial results;
- projected financial results; and
- capital position.

Additionally, the Committee reviews current and projected liquidity needs. As part of its procedures, the ALCO regularly reviews our interest rate risk by modeling the impact that changes in interest rates may have on earnings, particularly net interest income. The market value of portfolio equity, which is the net present value of an institution's existing assets less its liabilities and off-balance sheet instruments, is also modeled under several scenarios of changing interest rates. In both cases, results are evaluated and compared with the maximum potential change that is authorized by the Board of Directors.

**Our Risk When Interest Rates Change.** The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market interest rates change over time. Our loans generally have longer maturities than our deposits. Accordingly, our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is our most significant market risk.

We have utilized the following strategies in our efforts to manage interest rate risk:

- we have attempted, where possible, to extend the maturities of our deposits which typically fund our long-term assets;
- we have invested in securities with relatively short average lives, generally less than eight years; and
- we have added adjustable-rate securities to our investment portfolio.

**Brokered Deposits.** During the third quarter of 2014, management added the national brokered deposit market as an additional source of funds and to assist efforts in managing interest rate risk. Utilizing brokered deposits might result in increased regulatory scrutiny, as such deposits are not viewed as favorably as core retail deposits and there can be no assurance that the Bank will be allowed to include brokered deposits in its deposit mix in the future. While management will attempt to weigh the benefits of brokered deposits against the costs and risks, there can be no assurance that its conclusions will necessarily be aligned with those of the Bank's regulators.

**How We Measure the Risk of Interest Rate Changes.** We monitor our interest rate sensitivity on a quarterly basis to measure the change in net interest income in varying rate environments. Management uses various assumptions to evaluate the sensitivity of our operations to changes in interest rates. Although management believes these assumptions are reasonable, the interest rate sensitivity of our assets and liabilities on net interest income and the market value of portfolio equity could vary substantially if different assumptions were used or actual experience differs from these assumptions. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react differently to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities lag behind changes in market interest rates. Non-uniform changes and fluctuations in market interest rates across various maturities will also affect the results presented. In addition, certain assets, such as adjustable-rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. A portion of our adjustable-rate loans have interest rate floors below which the loan's contractual interest rate

may not adjust. Approximately 34.4% of our total loans were adjustable-rate loans at June 30, 2015. At that date, \$133.7 million, or 55.8% of these loans were at their floor, with a weighted-average interest rate of 4.4%. The inability of our loans to adjust downward can contribute to increased income in periods of declining interest rates. However, when loans are at their floors, there is a risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates. Furthermore, in the event of a significant change in interest rates, prepayment and early withdrawal levels would likely deviate from those assumed.

Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. We consider all these factors in monitoring our interest rate exposure.

The assumptions we use are based upon a combination of proprietary and market data that reflect historical results and current market conditions. These assumptions relate to interest rates, loan prepayments, deposit decay rates and the market value of certain assets under the various interest rate scenarios. We use market data to determine prepayments and maturities of loans, investments and borrowings and use our own assumptions on deposit decay rates. The exception to this is time deposits, which are modeled to reprice to market rates upon their stated maturities. We also assume that non-maturity deposits can be maintained with rate adjustments not directly proportionate to the change in market interest rates, based upon our historical deposit decay rates which are substantially lower than market decay rates. We have demonstrated in the past that the tiering structure of our deposit accounts during changing rate environments results in relatively lower volatility and less than market rate changes in our interest expense for deposits. We tier our deposit accounts by balance and rate, whereby higher balances within an account earn higher rates of interest. Therefore, deposits that are not very rate sensitive (generally, lower balance tiers) are separated from deposits that are rate sensitive (generally, higher balance tiers). When interest rates rise, we do not have to raise interest rates proportionately on less rate sensitive accounts to retain these deposits. These assumptions are based upon our analysis of our customer base, competitive factors and historical experience.

Our income simulation model examines changes in net interest income in which interest rates were assumed to remain at their base level, instantaneously increase by 100, 200 and 300 basis points or decline immediately by 100 basis points. Reductions of rates by 200 and 300 basis points were not reported due to the current low rate environment.

The following table illustrates the change in our net interest income at June 30, 2015 that would occur in the event of an instantaneous change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

Net Interest Income Change at June 30, 2015

| Basis Point Change in Rates | Net Interest Income<br>(Dollars in thousands) | % Change |
|-----------------------------|---|----------|
| +300                        | \$30,564                                      | 9.39%    |
| +200                        | 29,782  | 6.59     |
| +100                        | 28,959  | 3.65     |
| Base                        | 27,940  | —        |
| (100)                       | 26,883  | (3.78)   |

The following table illustrates the change in our net portfolio value (“NPV”) at June 30, 2015 that would occur in the event of an immediate change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

| Basis Point<br>Change in<br>Rates | Net Portfolio Value <sup>(1)</sup> |                          |          | Net Portfolio as % of<br>Portfolio Value of Assets |                         | Market<br>Value of<br>Assets <sup>(5)</sup> |
|-----------------------------------|------------------------------------|--------------------------|----------|--|-------------------------|---|
|                                   | Amount<br>(Dollars in thousands)   | \$ Change <sup>(2)</sup> | % Change | NPV Ratio <sup>(3)</sup>                           | % Change <sup>(4)</sup> |   |
| +300                              | \$174,019                          | \$(24,046)               | (12.14)  | 19.52  | (2.51)                  | \$891,474                                   |
| +200                              | 182,129                            | (15,936)                 | (8.05)   | 19.96  | (1.67)                  | 912,609                                     |
| +100                              | 191,384                            | (6,681)                  | (3.37)   | 20.46  | (0.70)                  | 935,484                                     |
| Base                              | 198,065                            | —                        | —        | 20.71  | —                       | 956,425                                     |
| (100)                             | 197,171                            | (894)                    | (0.45)   | 20.28  | (0.09)                  | 972,310                                     |

(1) The net portfolio value is the difference between the present value of the discounted cash flows of assets and liabilities and represents the market value of the Company's equity for any given interest rate scenario. Net portfolio value is useful for

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determining, on a market value basis, how equity changes in response to various interest rate scenarios. Large changes in net portfolio value reflect increased interest rate sensitivity and generally more volatile earnings streams.

- (2) The increase or decrease in net portfolio value at the indicated interest rates compared to the net portfolio value assuming no change in interest rates.
- (3) Net portfolio value divided by the market value of assets.
- (4) The increase or decrease in the net portfolio value divided by the market value of assets.
- (5) The market value of assets represents the value of assets under the various interest rate scenarios and reflects the sensitivity of those assets to interest rate changes.

The net interest income and net portfolio value tables presented above are predicated upon a stable balance sheet with no growth or change in asset or liability mix. In addition, the net portfolio value is based upon the present value of discounted cash flows using our estimates of current replacement rates to discount the cash flows. The effects of changes in interest rates in the net interest income table are based upon a cash flow simulation of our existing assets and liabilities and assuming that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. Delinquency rates may change when interest rates change as a result of changes in the loan portfolio mix, underwriting conditions, loan terms or changes in economic conditions that have a delayed effect on the portfolio. Even if interest rates change in the designated amounts, there can be no assurance that our assets and liabilities would perform as set forth above. Also, a change in U.S. Treasury rates in the designated amounts accompanied by a change in the shape of the Treasury yield curve would cause changes to the net portfolio value and net interest income other than those indicated above.

At June 30, 2015, we did not have any derivative financial instruments or trading accounts for any class of financial instruments, nor have we engaged in hedging activities or purchased off-balance sheet derivative instruments. Interest rate risk continues to be one of our primary risks as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

#### Item 4. Controls and Procedures

The management of First Financial Northwest, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (“Exchange Act”). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Additionally, in designing disclosure controls and procedures, our management was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Furthermore, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

- (a) Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2015 our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time

periods specified in the SEC's rules and forms.

Changes in Internal Controls: In the quarter ended June 30, 2015, there was no change in our internal control over (b) financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

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From time to time, we are engaged in various legal proceedings in the ordinary course of business, none of which are currently considered to have a material impact on our financial position or results of operations.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of our 2014 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) Not applicable

(b) Not applicable

(c) The following table summarizes First Financial Northwest's common stock repurchases during the second quarter of 2015:

| Period                                  | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Repurchased as Part of Publicly Announced Plan | Maximum Number of Shares that May Yet Be Repurchased Under the Plan |
|---|----------------------------------|------------------------------|---|---|
| April 1 - April 30, 2015 <sup>(1)</sup> | 25,000                           | \$ 12.00                     | 25,000  | 926,188   |
| May 1 - May 31, 2015 <sup>(2)</sup>     | 244,649                          | 12.00                        | 244,649   | 1,247,751   |
| June 1 - June 30, 2015 <sup>(2)</sup>   | 127,108                          | 11.83                        | 127,108   | 1,120,643   |
|   | 396,757                          | \$ 11.95                     | 396,757   | 1,120,643   |

<sup>(1)</sup> Shares repurchased under plan effective October 22, 2015 through April 22, 2015

<sup>(2)</sup> Shares repurchased under plan effective April 28, 2015 through October 28, 2015

In October 2014, the Board of Directors authorized the repurchase of up to 1,546,600 shares of the Company's common stock, or 10% of the Company's outstanding shares. This plan expired on April 22, 2015, at which time 620,412 shares had been repurchased at an average price per share of \$11.68. On April 22, 2015, the Board of Directors authorized a new share repurchase plan of an additional 1,492,400 shares of the Company's common stock, or 10% of shares outstanding. As of June 30, 2015, 371,757 shares had been repurchased at an average price per share of \$11.95. Shares may be repurchased under this plan through October 28, 2015.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.



Item 6. Exhibits and Financial Statement Schedules

(a) Exhibits

- 3.1 Articles of Incorporation of First Financial Northwest <sup>(1)</sup>
  - 3.2 Amended and Restated Bylaws of First Financial Northwest <sup>(2)</sup>
  - 4.0 Form of stock certificate of First Financial Northwest <sup>(1)</sup>
  - 10.1 Amended Employment Agreement between First Savings Bank Northwest and Joseph W. Kiley III <sup>(3)</sup>
  - 10.2 Form of Change in Control Severance Agreement for Executive Officers <sup>(4)</sup>
  - 10.3 Form of Supplemental Executive Retirement Agreement entered into by First Savings Bank with Joseph W. Kiley III <sup>(5)</sup>
  - 10.4 2008 Equity Incentive Plan <sup>(6)</sup>
  - 10.5 Forms of incentive and non-qualified stock option award agreements <sup>(7)</sup>
  - 10.6 Form of restricted stock award agreement <sup>(7)</sup>
  - 10.7 Settlement Agreement and Mutual Release with the Stilwell Group <sup>(8)</sup>
  - 10.8 Amendment No. 1 to the Settlement Agreement and Releases with the Stilwell Group <sup>(9)</sup>
  - 10.9 Amendment No. 2 to the Settlement Agreement and Releases with the Stilwell Group <sup>(10)</sup>
  - 10.10 Employment Agreement between First Savings Bank Northwest and Richard P. Jacobson <sup>(3)</sup>
  - 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
  - 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
  - 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act
- The following materials from First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2015, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements.\*

\*Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

- <sup>(1)</sup> Filed as an exhibit to First Financial Northwest's Registration Statement on Form S-1 (333-143539)
- <sup>(2)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated February 6, 2015.
- <sup>(3)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 5, 2013.
- <sup>(4)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated September 9, 2014.
- <sup>(5)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 31, 2012.
- <sup>(6)</sup> Filed as Appendix A to First Financial Northwest's definitive proxy statement dated April 15, 2008.
- <sup>(7)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated July 1, 2008.
- <sup>(8)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 20, 2012.
- <sup>(9)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated January 17, 2013.
- <sup>(10)</sup> Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated February 26, 2013.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FINANCIAL NORTHWEST, INC.

Date: August 6, 2015

By: /s/Joseph W. Kiley III  
Joseph W. Kiley III  
President and Chief Executive Officer (Principal Executive Officer)

Date: August 6, 2015

By: /s/Richard P. Jacobson  
Richard P. Jacobson  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)

Date: August 6, 2015

By: /s/Christine A. Huestis  
Christine A. Huestis  
Vice President and Controller (Principal Accounting Officer)

Exhibit Index

| Exhibit No. | Description   |
|-------------|---|
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