Sound Financial Bancorp, Inc.
Form 10-Q
August 12, 2016

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, 2016

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 001-35633

Sound Financial Bancorp, Inc.
(Exact Name of Registrant as Specified in its Charter)

Maryland	45-5188530
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2005 5th Avenue, Suite 200, Seattle, Washington	98121
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (206) 448-0884

None
(Former name, former address and former fiscal year, if changed since last report)

Indicate by checkmark 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 checkmark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting Company. See definition 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 (Do not check if smaller reporting company)	Smaller reporting company

Indicate by checkmark 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 registrant's classes of common stock as of the latest practicable date.

As of August 10, 2016, there were 2,486,899 shares of the registrant's common stock outstanding.

SOUND FINANCIAL BANCORP, INC.
FORM 10-Q
TABLE OF CONTENTS

2

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Balance Sheets (unaudited)
(In thousands, except share and per share amounts)

	June 30, 2016	December 31, 2015
ASSETS		
Cash and cash equivalents	$45,187	$ 48,264
Available-for-sale securities, at fair value	7,393	6,696
Loans held for sale	687	2,091
Loans	464,648	459,469
Allowance for loan losses	(4,838)	(4,636)
Total loans, net	459,810	454,833
Accrued interest receivable	1,592	1,608
Bank-owned life insurance (“BOLI”), net	11,914	11,746
Other real estate owned (“OREO”) and repossessed assets, net	780	769
Mortgage servicing rights, at fair value	3,026	3,249
Federal Home Loan Bank (“FHLB”) stock, at cost	2,073	2,212
Premises and equipment, net	5,088	5,335
Other assets	4,209	3,957
Total assets	$541,759	$ 540,760
LIABILITIES		
Deposits		
Interest-bearing	$384,323	$ 389,151
Noninterest-bearing demand	59,544	50,873
Total deposits	443,867	440,024
Borrowings	35,613	40,435
Accrued interest payable	90	72
Other liabilities	4,873	5,140
Advance payments from borrowers for taxes and insurance	505	569
Total liabilities	484,948	486,240
COMMITMENTS AND CONTINGENCIES (NOTE 7)		
STOCKHOLDERS' EQUITY		
Preferred stock, $0.01 par value, 1,000,000 shares authorized, none issued or outstanding	-	-
Common stock, $0.01 par value, 40,000,000 shares authorized, 2,480,830 and 2,469,206 shares issued and outstanding as of June 30, 2016 and December 31, 2015, respectively	25	25
Additional paid-in capital	23,247	23,002
Unearned shares - Employee Stock Ownership Plan (“ESOP”)	(911)	(911)
Retained earnings	34,228	32,240
Accumulated other comprehensive income, net of tax	222	164
Total stockholders’ equity	56,811	54,520
Total liabilities and stockholders’ equity	$541,759	$ 540,760

See notes to condensed consolidated financial statements

Table of Contents

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Income (unaudited)
(In thousands, except shares and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
INTEREST INCOME				
Loans, including fees	$6,051	$5,363	$12,003	$10,685
Interest and dividends on investments, cash and cash equivalents	92	47	181	102
Total interest income	6,143	5,410	12,184	10,787
INTEREST EXPENSE				
Deposits	654	661	1,342	1,322
Borrowings	55	19	84	47
Total interest expense	709	680	1,426	1,369
Net interest income	5,434	4,730	10,758	9,418
PROVISION FOR LOAN LOSSES	100	200	250	300
Net interest income after provision for loan losses	5,334	4,530	10,508	9,118
NONINTEREST INCOME				
Service charges and fee income	652	671	1,245	1,316
Earnings on cash surrender value of bank-owned life insurance	85	84	168	168
Mortgage servicing income	208	214	413	469
Fair value adjustment on mortgage servicing rights	(76)	347	(190)	169
Loss on sale of securities	-	-	-	(31)
Net gain on sale of loans	341	390	551	786
Total noninterest income	1,210	1,706	2,187	2,877
NONINTEREST EXPENSE				
Salaries and benefits	2,618	2,205	5,181	4,460
Operations	1,084	1,053	2,056	1,957
Regulatory assessments	125	230	280	296
Occupancy	380	448	765	773
Data processing	444	454	830	856
Net loss on OREO and repossessed assets	6	10	6	82
Total noninterest expense	4,657	4,400	9,118	8,424
Income before provision for income taxes	1,887	1,836	3,577	3,571
Provision for income taxes	633	589	1,217	1,116
Net income	$1,254	$1,247	$2,360	$2,455
Earnings per common share:				
Basic	$0.51	$0.50	$0.95	$0.98
Diluted	$0.49	$0.48	$0.92	$0.94
Weighted average number of common shares outstanding:				
Basic	2,481,093	2,510,673	2,479,422	2,517,734
Diluted	2,578,948	2,601,984	2,575,128	2,602,777

See notes to condensed consolidated financial statements

Table of Contents

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Comprehensive Income (unaudited)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income	$1,254	$1,247	$2,360	$2,455
Available for sale securities:				
Unrealized gains (losses) arising during the period, net of tax provision (benefits) of $27, $9, $30 and $(12), respectively	52	21	58	(17)
Reclassification adjustments for the net losses realized in earnings, net of tax benefit of $0, $0, $0 and $11	-	-	-	20
Other comprehensive income, net of tax	52	21	58	3
Comprehensive income	$1,306	$1,268	$2,418	$2,458

See notes to condensed consolidated financial statements

Table of Contents

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Stockholders' Equity
For the Six Months Ended June 30, 2016 and 2015 (unaudited)
(Dollars in thousands, except per share amounts)

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Income net of tax	Total Stockholders' Equity
Balances at December 31, 2014	2,524,645	$ 25	$ 23,552	$ (1,140)	$ 28,024	$ 183	$ 50,644
Net income					2,455		2,455
Other comprehensive income, net of tax						3	3
Share-based compensation			207				207
Cash dividends paid on common stock ($0.11 per share)					(277)		(277)
Restricted stock awards issued	10,208						-
Restricted stock forfeited and retired	(7,535)						-
Common stock repurchased	(63,371)		(1,261)				(1,261)
Exercise of options	1,783		17				17
Balances at June 30, 2015	2,465,730	$ 25	$ 22,515	$ (1,140)	$ 30,202	$ 186	$ 51,788

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Income net of tax	Total Stockholders' Equity
Balances at December 31, 2015	2,469,206	$ 25	$ 23,002	$ (911)	$ 32,240	$ 164	$ 54,520
Net income					2,360		2,360
Other comprehensive income, net of tax						58	58
Share-based compensation			228				228
Cash dividends paid on common stock ($0.15 per share)					(372)		(372)
Restricted stock awards issued	11,606						-
Restricted stock forfeited and retired	(1,059)						-
Exercise of options	1,077		17				17
Balances at June 30, 2016	2,480,830	$ 25	$ 23,247	$ (911)	$ 34,228	$ 222	$ 56,811

See notes to condensed consolidated financial statements

Table of Contents

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Cash Flows (unaudited)
(In thousands)

	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 2,360	$ 2,455
Adjustments to reconcile net income to net cash from operating activities:		
Accretion of net discounts on investments	17	79
Loss on sale of securities	-	31
Dividends paid on FHLB stock	32	-
Provision for loan losses	250	300
Depreciation and amortization	394	295
Compensation expense related to stock options and restricted stock	228	207
Changes in fair value of mortgage servicing rights	482	193
Additions to mortgage servicing rights	(259)	(436)
Increase in cash surrender value of BOLI	(168)	(168)
Gain on sale of loans	(551)	(786)
Proceeds from sale of loans	36,080	44,610
Originations of loans held for sale	(34,125)	(46,075)
Net Loss on sale and write-downs of OREO and repossessed assets	8	22
Change in operating assets and liabilities:		
Accrued interest receivable	16	3
Other assets	(282)	(710)
Accrued interest payable	18	3
Other liabilities	(267)	608
Net cash from operating activities	4,233	631
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from principal payments, maturities and sales of available for sale securities	737	3,516
Purchases of available for sale securities	(1,363)	-
FHLB stock redeemed	107	579
Net increase in loans	(5,378)	(4,833)
Proceeds from sale of OREO and other repossessed assets	132	400
Purchases of premises and equipment, net	(147)	(479)
Net cash used by investing activities	(5,912)	(817)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	3,843	10,820
Proceeds from borrowings	56,500	36,000
Repayment of borrowings	(61,322)	(40,322)
Dividends paid on common stock	(372)	(277)
Net change in advances from borrowers for taxes and insurance	(64)	7
Proceeds from stock option exercises	17	17
Repurchase of common stock	-	(1,261)
Net cash (used by) from financing activities	(1,398)	4,984
Net change in cash and cash equivalents	(3,077)	4,798
Cash and cash equivalents, beginning of period	48,264	29,289
Cash and cash equivalents, end of period	$ 45,187	$ 34,087
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for income taxes	$ 1,000	$ 625

Interest paid on deposits and borrowings	$ 1,408	$ 1,366
Noncash net transfer from loans to OREO and repossessed assets	$ 712	$ 481

See notes to condensed consolidated financial statements

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 – Basis of Presentation

The accompanying financial information is unaudited and has been prepared from the consolidated financial statements of Sound Financial Bancorp, Inc., and its wholly owned subsidiary, Sound Community Bank. References in this document to Sound Financial Bancorp refer to Sound Financial Bancorp, Inc. and its predecessor, Sound Financial, Inc., a federal corporation, and references to the "Bank" refer to Sound Community Bank. References to "we," "us," and "our" or the "Company" means Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank unless the context otherwise requires.

These unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission ("SEC"). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. These unaudited financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC on March 30, 2016 ("2015 Form 10-K"). The results for the interim periods are not necessarily indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2015, included in the 2015 Form 10-K. Certain amounts in the prior quarters' consolidated financial statements have been reclassified to conform to the current presentation. These classifications do not have an impact on previously reported consolidated net income, retained earnings, stockholders' equity or earnings per share.

Note 2 – Accounting Pronouncements Recently Issued or Adopted

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606), which creates Topic 606 and supersedes Topic 605, Revenue Recognition. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), which postponed the effective date of 2014-09. In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net, which amended the principal versus agent implementation guidance set for in ASU 2014-09. Among other things, ASU 2016-08 clarifies that an entity should evaluate whether it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. The ASU amends certain aspects of the guidance set forth in the FASB's new revenue standard related to identifying performance obligations and licensing implementation. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the new ASU requires companies to use more judgment and make more estimates than under current guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The standard is effective for public entities for interim and annual periods beginning after December 15, 2017; early adoption is not permitted. For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company is currently evaluating the provisions to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805). The ASU simplifies the accounting for measurement period adjustments. The amendments require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period when the adjustment amounts are determined. The acquirer is required to record in the same period's financial statements the effect on earnings from changes in depreciation, amortization, or other income effects resulting from the change to provisional amounts, calculated as if the accounting had been completed at the acquisition date. The acquirer must present separately on the income statement, or disclose in the notes, the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the provisional amount had been recognized at the acquisition date. ASU 2015-16 is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. This ASU is not expected to have a material effect on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments. This ASU requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. In addition, the amendment requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. This ASU also eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The amendment also requires a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument specific credit risk (also referred to as “own credit”) when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU No. 2016-01 is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted for certain provisions. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

In February 2016, FASB issued ASU No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize, on the balance sheet, the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. The adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-05, Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. A contract novation refers to replacing one of the parties to a derivative instrument with a new party. This ASU clarifies that a change in counterparty in a derivative instrument does not, in and of itself, require dedesignation of that hedging relationship and therefore discontinue the application of hedge accounting. ASU 2016-05 is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted in any interim or annual period. The adoption of ASU 2016-05 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting. The ASU eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an adjustment must be made to the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The ASU is effective for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption of the update is permitted. The Company does not expect this ASU to have a material impact on the Company’s consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net). The amendments in this ASU require entities to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. The adoption of ASU No. 2016-08 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends ASC Topic 718, Compensation - Stock Compensation. The ASU includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. The ASU is effective for annual and interim periods beginning after December 15, 2016. The adoption of ASU is being reviewed for any material impact there may be on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU replaces the existing incurred loss impairment methodology that recognizes credit losses when a probable loss has been incurred with new methodology where loss estimates are based upon lifetime expected credit losses. The amendments in this ASU require a financial asset that is measured at amortized cost to be presented at the net amount expected to be collected. The income statement would then reflect the measurement of credit losses for newly recognized financial assets as well as changes to the expected credit losses that have taken place during the reporting period. The measurement of expected credit losses will be based on historical information, current conditions, and reasonable and supportable forecasts that impact the collectability of the reported amount. Available-for-sale securities will bifurcate the fair value mark and establish an allowance for credit losses through the income statement for the credit portion of that mark. The interest portion will continue to be recognized through accumulated other comprehensive income or loss. The change in allowance recognized as a result of adoption will occur through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the ASU is adopted. The amendments in this ASU are effective for fiscal years beginning after December 15, 2019 with early adoption permitted after December 15, 2018. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 3 – Investments

The amortized cost and fair value of our available-for-sale ("AFS") securities and the corresponding amounts of gross unrealized gains and losses at the dates indicated were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2016				
Municipal bonds	$ 3,272	$ 272	$ -	$ 3,544
Agency mortgage-backed securities	3,387	83	-	3,470
Non-agency mortgage-backed securities	397	-	(18)	379
Total	$ 7,056	$ 355	$ (18)	$ 7,393
December 31, 2015				
Municipal bonds	$ 1,912	$ 184	$ -	$ 2,096
Agency mortgage-backed securities	4,088	102	(18)	4,172
Non-agency mortgage-backed securities	449	-	(21)	428
Total	$ 6,449	$ 286	$ (39)	$ 6,696

The amortized cost and fair value of AFS securities at June 30, 2016, by contractual maturity, are shown below (in thousands). Expected maturities of AFS securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	At June 30, 2016	
	Amortized Cost	Fair Value
Due within five years	$1,115	$1,120
Due in five to ten years	505	534
Due after ten years	5,436	5,739
Total	$7,056	$7,393

No securities were pledged to secure Washington State Public Funds as of June 30, 2016.

There were no sales of AFS securities during the three or six months ended June 30, 2016. There were no sales of AFS securities during the three months ended June 30, 2015. We sold $1.7 million of non-agency mortgage-backed securities generating gross losses of $31,000 and no gross gains during the six months ended June 30, 2015.

The following tables summarize at the dates indicated the aggregate fair value and gross unrealized loss by length of time of those investments that have been continuously in an unrealized loss position (in thousands):

	June 30, 2016					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Non-agency mortgage-backed securities	$-	$ -	$379	$ (18)	$379	$ (18)

Total	$-	$ -	$379	$ (18)	$379	$ (18)

	December 31, 2015					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Agency mortgage-backed securities	$	$	$1,370	$ (18)	$1,370	$ (18)
Non-agency mortgage-backed securities	-	-	428	(21)	428	(21)
Total	$	$	$1,798	$ (39)	$1,798	$ (39)

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents the cumulative roll forward of credit losses recognized in earnings during the three and six months ended June 30, 2016 and 2015 relating to the Company's non-U.S. agency mortgage-backed securities (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Estimated credit losses, beginning balance	$ -	$ -	$ -	$ 450
Additions for credit losses not previously recognized	-	-	-	-
Reduction for increases in cash flows	-	-	-	-
Reduction of related OTTI due to sales	-	-	-	(450)
Reduction for realized losses	-	-	-	-
Estimated credit losses, ending balance	$ -	$ -	$ -	$ -

Note 4 – Loans

The composition of the loan portfolio at the dates indicated, excluding loans held for sale, was as follows (in thousands):

	At June 30, 2016	At December 31, 2015
Real estate loans:		
One- to four- family	$ 149,874	$ 141,125
Home equity	31,804	31,573
Commercial and multifamily	164,916	175,312
Construction and land	57,792	57,043
Total real estate loans	$ 404,386	$ 405,053
Consumer loans:		
Manufactured homes	15,114	13,798
Other consumer	24,953	23,030
Total consumer loans	40,067	36,828
Commercial business loans	21,967	19,295
Total loans	466,420	461,176
Deferred fees	(1,772)	(1,707)
Total loans, gross	464,648	459,469
Allowance for loan losses	(4,838)	(4,636)
Total loans, net	$ 459,810	$ 454,833

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of June 30, 2016 (in thousands):

	One- to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Unallocated	Total
Allowance for loan losses:									
Individually evaluated for impairment	$637	$100	$424	$23	$56	$24	$38	$ -	$1,302
Collectively evaluated for impairment	1,076	401	953	365	133	197	133	278	3,536
Ending balance	$1,713	$501	$1,377	$388	$189	$221	$171	$ 278	$4,838
Loans receivable:									
Individually evaluated for impairment	$5,612	$1,049	$4,861	$87	$394	$24	$646	$ -	$12,673
Collectively evaluated for impairment	144,262	30,755	160,055	57,705	14,720	24,929	21,321	-	453,747
Ending balance	$149,874	$31,804	$164,916	$57,792	$15,114	$24,953	$21,967	$ -	$466,420

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2015 (in thousands):

	One-to-four family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Unallocated	Total
Allowance for loan losses:									
Individually evaluated for impairment	$647	$110	$36	$18	$63	$-	$8	$ -	$882
Collectively evaluated for impairment	1,192	497	885	364	238	188	149	241	3,754
Ending balance	$1,839	$607	$921	$382	$301	$188	$157	$ 241	$4,636
Loans receivable:									
Individually evaluated for impairment	$5,779	$904	$1,966	$91	$361	$5	$114	$ -	$9,220

Collectively evaluated for impairment	135,346	30,669	173,346	56,952	13,437	23,025	19,181	-	451,956
Ending balance	$141,125	$31,573	$175,312	$ 57,043	$ 13,798	$23,030	$ 19,295	$ -	$461,176

12

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the activity in the allowance for loan losses for the three months ended June 30, 2016 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One-to four- family	$ 1,733	$ (7)	$ -	$ (13)	$ 1,713
Home equity	597	-	63	(159)	501
Commercial and multifamily	1,267	-	-	110	1,377
Construction and land	463	-	-	(75)	388
Manufactured homes	202	-	3	(16)	189
Other consumer	233	(3)	2	(11)	221
Commercial business	164	(29)	-	36	171
Unallocated	50	-	-	228	278
Total	$ 4,709	$ (39)	$ 68	$ 100	$ 4,838

The following table summarizes the activity in the allowance for loan losses for the six months ended June 30, 2016 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One-to four- family	$ 1,839	$ (72)	$ -	$ (54)	$ 1,713
Home equity	607	-	65	(171)	501
Commercial and multifamily	921	-	-	456	1,377
Construction and land	382	-	-	6	388
Manufactured homes	301	-	5	(117)	189
Other consumer	188	(21)	4	50	221
Commercial business	157	(29)	-	43	171
Unallocated	241	-	-	37	278
Total	$ 4,636	$ (122)	$ 74	$ 250	$ 4,838

The following table summarizes the activity in the allowance for loan losses for the three months ended June 30, 2015 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One-to four- family	$ 1,429	$ -	$ -	$ 165	$ 1,594
Home equity	514	-	6	(11)	509
Commercial and multifamily	1,406	-	-	101	1,507
Construction and land	414	(40)	-	(29)	345
Manufactured homes	184	(32)	2	39	193
Other consumer	154	(3)	3	29	183
Commercial business	104	-	-	41	145
Unallocated	231	-	-	(135)	96
Total	$ 4,436	$ (75)	$ 11	$ 200	$ 4,572

The following table summarizes the activity in the allowance for loan losses for the six months ended June 30, 2015 (in thousands):

	Beginning Allowance	Charge-offs	Recoveries	Provision	Ending Allowance
One-to four- family	$ 1,442	$ (21)	$ -	$ 173	$ 1,594
Home equity	601	(19)	10	(83)	509
Commercial and multifamily	1,244	-	-	263	1,507
Construction and land	399	(40)	-	(14)	345
Manufactured homes	193	(32)	5	27	193
Other consumer	167	(27)	9	34	183
Commercial business	108	-	-	37	145
Unallocated	233	-	-	(137)	96
Total	$ 4,387	$ (139)	$ 24	$ 300	$ 4,572

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

Credit Quality Indicators. Federal regulations provide for the classification of lower quality loans as substandard, doubtful or loss. 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 we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without establishment of a specific loss reserve is not warranted.

When we classify problem loans as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent to address the risk specifically (if the loan is impaired) or we may allow the loss to be addressed in the general allowance (if the loan is not impaired). General allowances represent loss reserves which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem loans. When the Company classifies problem loans as a loss, we charge off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose us to sufficient risk to warrant classification as substandard, doubtful or loss but possess identified weaknesses are classified as either watch or special mention assets. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the Federal Deposit Insurance Corporation ("FDIC"), the Bank's federal regulatory, and the Washington Department of Financial Institutions, the Bank's state banking regulator, which can order the establishment of additional loss allowances. Pass rated loans are loans that are not otherwise classified or criticized.

The following table represents the internally assigned grades as of June 30, 2016 by type of loan (in thousands):

	One- to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
Grade:								
Pass	$145,696	$30,464	$ 158,819	$ 54,586	$ 14,863	$24,877	$ 21,554	$450,859
Watch	1,089	538	1,763	3,206	115	52	25	6,788
Special Mention	1,408	-	1,415	-	31	-	-	2,854
Substandard	1,681	802	2,919		105	24	388	5,919
Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	$149,874	$31,804	$ 164,916	$ 57,792	$ 15,114	$24,953	$ 21,967	$466,420

The following table represents the internally assigned grades as of December 31, 2015 by type of loan (in thousands):

	One- to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
Grade:								
Pass	$136,879	$30,310	$ 169,072	$ 55,984	$ 13,621	$22,967	$ 18,449	$447,282
Watch	1,015	609	4,810	1,059	96	58	846	8,493
Special Mention	1,409	-	1,430	-	33	-	-	2,872
Substandard	1,822	654	-	-	48	5	-	2,529

Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	$141,125	$31,573	$ 175,312	$ 57,043	$ 13,798	$23,030	$ 19,295	$461,176

Nonaccrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are automatically placed on nonaccrual once the loan is 90 days past due or sooner if, in management's opinion, the borrower may be unable to meet payment of obligations as they become due, as well as when required by regulatory authorities.

The following table presents the recorded investment in nonaccrual loans as of June 30, 2016 and December 31, 2015, by type of loan (in thousands):

	June 30, 2016	December 31, 2015
One- to four- family	$875	$ 1,157
Home equity	494	344
Commercial and multifamily	2,143	-
Construction and land	164	-
Manufactured homes	79	27
Other consumer	22	-
Total	$3,777	$ 1,528

14

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

The following table represents the aging of the recorded investment in past due loans as of June 30, 2016 by type of loan (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater Past Due	90 Days and Greater Past Due and Still Accruing	Total Past Due	Current	Total Loans
One-to four- family	$ -	$ 458	$ 730	$ -	$ 1,188	$ 148,686	$ 149,874
Home equity	469	120	354	-	943	30,861	31,804
Commercial and multifamily	231	-	-	-	231	164,685	164,916
Construction and land	-	64	-	-	64	57,728	57,792
Manufactured homes	61	-	62	-	123	14,991	15,114
Other consumer	11	3	21	-	35	24,918	24,953
Commercial business	5	-	-	-	5	21,962	21,967
Total	$ 777	$ 645	$ 1,167	$ -	$ 2,589	$ 463,831	$ 466,420

The following table represents the aging of the recorded investment in past due loans as of December 31, 2015 by type of loan (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Greater Past Due	90 Days and Greater Past Due and Still Accruing	Total Past Due	Current	Total Loans
One-to four- family	$ 2,453	$ 265	$ 881	$ 117	$ 3,716	$ 137,409	$ 141,125
Home equity	352	60	296	-	708	30,865	31,573
Commercial and multifamily	203	-	-	-	203	175,109	175,312
Construction and land	65	-	-	-	65	56,978	57,043
Manufactured homes	103	27	-	-	130	13,668	13,798
Other consumer	17	26	-	-	43	22,987	23,030
Commercial business	154	8	-	-	162	19,133	19,295
Total	$ 3,347	$ 386	$ 1,177	$ 117	$ 5,027	$ 456,149	$ 461,176

Nonperforming Loans. Loans are considered nonperforming when they are placed on nonaccrual and/or when they are considered to be nonperforming troubled debt restructurings ("TDRs") and/or when they are 90 days or greater past due and still accruing. A TDR is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession of some kind. Nonperforming TDRs include TDRs that do not have sufficient payment history (typically greater than six months) to be considered performing or TDRs that have become 30 or more days past due.

The following table represents the credit risk profile of our loan portfolio based on payment activity as of June 30, 2016 by type of loan (in thousands):

	One- to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
Performing	$148,631	$31,143	$ 162,772	$ 57,792	$ 14,964	$24,931	$ 21,706	$461,939
Nonperforming	1,244	661	2,144	-	150	22	261	4,482
Total	$149,874	$31,804	$ 164,916	$ 57,792	$ 15,114	$24,953	$ 21,967	$466,420

The following table represents the credit risk profile of our loan portfolio based on payment activity as of December 31, 2015 by type of loan (in thousands):

	One- to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
Performing	$139,484	$31,146	$ 175,312	$ 57,043	$ 13,736	$23,030	$ 19,295	$459,046
Nonperforming	1,641	427	-		62	-	-	2,130
Total	$141,125	$31,573	$ 175,312	$ 57,043	$ 13,798	$23,030	$ 19,295	$461,176

15

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 loan. In the process of identifying loans as impaired, we take 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 on a case by case basis, after taking into consideration the totality of circumstances surrounding the loans and the borrowers, including payment history. Impairment is measured on a loan by loan basis for all loans in the portfolio. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the allowance for loan losses.

Impaired loans at June 30, 2016 and December 31, 2015 by type of loan were as follows (in thousands):

	June 30, 2016			
		Recorded Investment		
	Unpaid Principal Balance	Without Allowance	With Allowance	Related Allowance
One- to four- family	$6,066	$2,482	$ 3,129	$ 639
Home equity	1,079	606	443	100
Commercial and multifamily	4,862	2,191	2,671	424
Construction and land	87	-	87	23
Manufactured homes	414	129	265	56
Other consumer	24	-	24	24
Commercial business	646	149	497	37
Total	$13,178	$5,558	$ 7,116	$ 1,303

	December 31, 2015			
		Recorded Investment		
	Unpaid Principal Balance	Without Allowance	With Allowance	Related Allowance
One- to four- family	$6,011	$499	$5,280	$ 647
Home equity	994	162	742	110
Commercial and multifamily	1,966	1,430	536	36
Construction and land	91	-	91	18
Manufactured homes	366	-	361	63
Other consumer	5	-	5	-
Commercial business	114	-	114	8
Total	$9,547	$2,091	$7,129	$ 882

Table of Contents
SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements (unaudited)

Income on impaired loans for the three and six months ended June 30, 2016 and December 31, 2015 by type of loan were as follows (in thousands):

	Three Months Ended June 30, 2016		Three Months Ended June 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
One- to four- family	$5,539	$ 72	$4,829	$ 57
Home equity	993	15	1,149	9
Commercial and multifamily	4,887	66	2,767	40
Construction and land	88	1	158	1
Manufactured homes	387	9	387	7
Other consumer	26	1	60	-
Commercial business	573	11	121	1
Total	$12,493	$ 175	$9,471	$ 115

	Six Months Ended June 30, 2016		Six Months Ended June 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
One- to four- family	$5,619	$ 140	$4,614	$