FS Bancorp, Inc.
Form 10-Q
November 09, 2016

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

FORM 10-Q
(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 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: 333-177125
FS BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington	45-4585178
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6920 220th Street SW, Mountlake Terrace, Washington 98043
(Address of principal executive offices; Zip Code)

(425) 771-5299
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes [X] No [ ]

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]	Accelerated filer [ ]

Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 4, 2016, there were 3,057,753 outstanding shares of the registrant's common stock.

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As used in this report, the terms “we,” “our,” and “us,” and “Company” refer to FS Bancorp, Inc. and its consolidated subsidiary, unless the context indicates otherwise. When we refer to “Bank” in this report, we are referring to 1st Security Bank of Washington, the wholly owned subsidiary of FS Bancorp, Inc.

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Item 1. Financial Statements
FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share amounts) (Unaudited)

ASSETS	September 30, 2016	December 31, 2015
Cash and due from banks	$3,445	$1,708
Interest-bearing deposits at other financial institutions	13,068	22,747
Total cash and cash equivalents	16,513	24,455
Certificates of deposit at other financial institutions	14,009	12,421
Securities available-for-sale, at fair value	80,762	55,217
Loans held for sale, at fair value	77,129	44,925
Loans receivable, net	592,800	502,535
Accrued interest receivable	2,557	2,107
Premises and equipment, net	15,071	13,856
Federal Home Loan Bank (“FHLB”) stock, at cost	2,004	4,551
Bank owned life insurance (“BOLI”), net	9,983	9,772
Servicing rights, held at the lower of cost or fair value	7,654	5,811
Goodwill	2,312	—
Core deposit intangible, net	1,857	—
Other assets	4,835	1,911
TOTAL ASSETS	$827,486	$677,561
LIABILITIES		
Deposits:		
Noninterest-bearing accounts	$153,095	$72,247
Interest-bearing accounts	550,069	412,931
Total deposits	703,164	485,178
Borrowings	21,030	98,769
Subordinated note:		
Principal amount	10,000	10,000
Unamortized debt issuance costs	(180)	(195)
Total subordinated note less unamortized debt issuance costs	9,820	9,805
Other liabilities	13,915	8,469
Total liabilities	747,929	602,221
COMMITMENTS AND CONTINGENCIES (NOTE 9)		
STOCKHOLDERS’ EQUITY		
Preferred stock, $.01 par value; 5,000,000 shares authorized; none issued or outstanding	—	—
Common stock, $.01 par value; 45,000,000 shares authorized; 3,057,753 and 3,242,120 shares issued and outstanding at September 30, 2016, and December 31, 2015, respectively	31	32
Additional paid-in capital	26,866	30,692
Retained earnings	53,326	46,175
Accumulated other comprehensive income, net of tax	773	78
Unearned shares - Employee Stock Ownership Plan (“ESOP”)	(1,439)	(1,637)
Total stockholders’ equity	79,557	75,340
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	$827,486	$677,561

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands, except share amounts) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
INTEREST INCOME				
Loans receivable including fees	$9,241	$7,730	$26,014	$22,042
Interest and dividends on investment securities, cash and cash equivalents, and certificates of deposit at other financial institutions	538	329	1,751	874
Total interest and dividend income	9,779	8,059	27,765	22,916
INTEREST EXPENSE				
Deposits	808	866	2,411	2,425
Borrowings	50	56	177	195
Subordinated note	171	—	512	—
Total interest expense	1,029	922	3,100	2,620
NET INTEREST INCOME	8,750	7,137	24,665	20,296
PROVISION FOR LOAN LOSSES	600	600	1,800	1,800
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	8,150	6,537	22,865	18,496
NONINTEREST INCOME				
Service charges and fee income	899	528	2,489	1,452
Gain on sale of loans	5,922	3,632	14,722	11,565
Gain on sale of investment securities	146	—	146	76
Earnings on cash surrender value of BOLI	71	51	211	146
Other noninterest income	210	165	557	486
Total noninterest income	7,248	4,376	18,125	13,725
NONINTEREST EXPENSE				
Salaries and benefits	6,287	4,295	16,510	12,461
Operations	1,450	1,118	4,221	3,209
Occupancy	597	497	1,775	1,388
Data processing	537	380	1,576	1,132
Gain on sale of other real estate owned (“OREO”)	—	—	(150)	—
Loan costs	715	379	1,789	1,129
Professional and board fees	502	479	1,490	1,268
Federal Deposit Insurance Corporation (“FDIC”) insurance	98	69	306	229
Marketing and advertising	202	183	553	458
Acquisition costs	—	432	389	432
Amortization of core deposit intangible	140	—	382	—
Recovery on servicing rights	(216)	—	(2)	—
Total noninterest expense	10,312	7,832	28,839	21,706
INCOME BEFORE PROVISION FOR INCOME TAXES	5,086	3,081	12,151	10,515
PROVISION FOR INCOME TAXES	1,629	1,086	4,198	3,656
NET INCOME	$3,457	$1,995	$7,953	$6,859

Basic earnings per share	$1.21	$0.67	$2.74	$2.31
Diluted earnings per share	$1.18	$0.66	$2.66	$2.28

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net Income	$3,457	$1,995	$7,953	$6,859
Other comprehensive income, before tax:				
Securities available-for-sale:				
Unrealized holding gain during period	29	391	1,224	253
Income tax provision related to unrealized holding gain	(8)	(133)	(433)	(86)
Reclassification adjustment for realized gain included in net income	(146)	—	(146)	(76)
Income tax provision related to reclassification for realized gain	50	—	50	26
Other comprehensive (loss) income, net of tax	(75)	258	695	117
COMPREHENSIVE INCOME	$3,382	$2,253	$8,648	$6,976

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(Dollars in thousands, except share amounts) (Unaudited)

	Common Stock				Accumulated		
	Shares	Amount	Additional Paid-in Capital	Retained Earnings	Other Comprehensive Income, Net of Tax	Unearned ESOP Shares	Total Stockholders' Equity
BALANCE, January 1, 2015	3,235,625	$ 32	$ 29,450	$ 38,125	$ 117	$ (1,888)	$ 65,836
Net income	—	—	—	6,859	—	—	6,859
Dividends paid ($0.19 per share)	—	—	—	(611)	—	—	(611)
Share-based compensation	—	—	560	—	—	—	560
Common stock repurchased	(4,605)	—	(101)	—	—	—	(101)
Stock options exercised	10,100	—	170	—	—	—	170
Other comprehensive income, net of tax	—	—	—	—	117	—	117
ESOP shares allocated	—	—	210	—	—	198	408
BALANCE, September 30, 2015	3,241,120	$ 32	$ 30,289	$ 44,373	$ 234	$ (1,690)	$ 73,238
BALANCE, January 1, 2016	3,242,120	$ 32	$ 30,692	$ 46,175	$ 78	$ (1,637)	$ 75,340
Net income	—	—	—	7,953	—	—	7,953
Dividends paid ($0.26 per share)	—	—	—	(802)	—	—	(802)
Share-based compensation	—	—	588	—	—	—	588
Restricted stock awards	4,500	—	—	—	—	—	—
Common stock repurchased	(198,167)	(1)	(4,902)	—	—	—	(4,903)
Stock options exercised	9,300	—	157	—	—	—	157
Other comprehensive income, net of tax	—	—	—	—	695	—	695
ESOP shares allocated	—	—	331	—	—	198	529
BALANCE, September 30, 2016	3,057,753	$ 31	$ 26,866	$ 53,326	$ 773	$ (1,439)	$ 79,557

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands) (Unaudited)

	Nine Months Ended September 30,	
CASH FLOWS FROM OPERATING ACTIVITIES	2016	2015
Net income	$7,953	$6,859
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	1,800	1,800
Depreciation, amortization and accretion	3,779	1,598
Compensation expense related to stock options and restricted stock awards	588	560
ESOP compensation expense for allocated shares	529	408
Increase in cash surrender value of BOLI	(211)	(146)
Gain on sale of loans held for sale	(14,722)	(11,565)
Origination of loans held for sale	(584,073)	(447,964)
Proceeds from sale of loans held for sale	564,218	429,411
Gain on sale of investment securities	(146)	(76)
Recovery of servicing rights	(2)	—
Gain on sale of OREO	(150)	—
Changes in operating assets and liabilities		
Accrued interest receivable	(450)	(499)
Other assets	(7,481)	(725)
Other liabilities	5,063	3,091
Net cash used by operating activities	(23,305)	(17,248)
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	13,577	4,178
Maturities, prepayments, sales, and calls	9,039	4,574
Purchases	(47,432)	(13,729)
Maturities of interest-bearing time deposits	292	496
Purchase of interest-bearing time deposits	(1,882)	(7,136)
Loan originations and principal collections, net	(93,871)	(80,887)
Purchase of portfolio loans	—	(16,113)
Purchase of BOLI	—	(3,000)
Proceeds from sale of other real estate owned, net	682	—
Purchase of premises and equipment, net	(2,287)	(1,068)
FHLB stock purchased	(7,743)	(5,468)
FHLB stock redeemed	10,290	4,146
Net cash received from acquisition	180,356	—
Net cash from (used by) investing activities	61,021	(114,007)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	37,630	79,439
Proceeds from borrowings	259,500	305,837
Repayments of borrowings	(337,240)	(263,602)
Dividends paid	(802)	(611)
Proceeds from stock options exercised	157	170
Common stock repurchased	(4,903)	(101)

Net cash (used by) from financing activities	(45,658)	121,132

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NET DECREASE IN CASH AND CASH EQUIVALENTS	(7,942)	(10,123)
CASH AND CASH EQUIVALENTS, beginning of period	24,455	15,555
CASH AND CASH EQUIVALENTS, end of period	$16,513	$5,432
SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for:		
Interest	$2,931	$2,623
Income taxes	$4,420	$3,666
Assets acquired in acquisition of branches	$181,575	$—
Liabilities assumed in acquisition of branches	$186,393	$—
SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES		
Change in unrealized gain on investment securities	$1,079	$177
Property received in settlement of loans	$525	$—
Retention of mortgage servicing rights from loan sales	$2,927	$2,823

See accompanying notes to these consolidated financial statements.

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NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations - FS Bancorp, Inc. (the "Company") was incorporated in September 2011 as the proposed holding company for 1st Security Bank of Washington (the "Bank" or "1st Security Bank") in connection with the Bank's conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based savings bank with 11 branches and four loan production offices in suburban communities in the greater Puget Sound area which includes Snohomish, King, Pierce, Jefferson, Kitsap, and Clallam counties, and one loan production office in the market area of the Tri-Cities, Washington. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals. The Bank acquired four retail bank branches from Bank of America (two in Clallam and two in Jefferson counties) on January 22, 2016, and these branches opened as 1st Security Bank branches on January 25, 2016. The Company and its subsidiary are subject to regulation by certain federal and state agencies and undergo periodic examination by these regulatory agencies.

Pursuant to the Plan of Conversion (the "Plan"), the Company's Board of Directors adopted an employee stock ownership plan ("ESOP") which purchased 8% of the common stock in the open market or 259,210 shares. As provided for in the Plan, the Bank also established a liquidation account in the amount of retained earnings at December 31, 2011. The liquidation account is maintained for the benefit of eligible savings account holders at June 30, 2007, and supplemental eligible account holders as of March 31, 2012, who maintain deposit accounts at the Bank after the conversion. The conversion was accounted for as a change in corporate form with the historic basis of the Company's assets, liabilities, and equity unchanged as a result.

Financial Statement Presentation - The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. 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"). It is recommended that these unaudited interim consolidated financial statements be read in conjunction with the Company's Annual Report on Form 10-K with all of the audited information and footnotes required by U.S. GAAP for complete financial statements for the year ended December 31, 2015, as filed with the SEC on March 25, 2016. In the opinion of management, all normal adjustments and recurring accruals considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included.

The results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016, or any other future period. The preparation of financial statements, in conformity with U.S. GAAP, requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to change in the near term are allowances for loan losses, fair value of measurements, and servicing assets.

Amounts presented in the consolidated financial statements and footnote tables are rounded and presented in thousands of dollars except per share amounts. In the narrative footnote discussion, amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above $1.0 million. Amounts below $1.0

million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been reclassified to conform to the 2016 presentation with no change to consolidated net income or stockholders' equity previously reported.

Principles of Consolidation - The consolidated financial statements include the accounts of FS Bancorp, Inc. and its wholly owned subsidiary, 1st Security Bank of Washington. All material intercompany accounts have been eliminated in consolidation.

Segment Reporting - The Company's major line of business is community banking. Management has determined that the Company operates as a single operating segment based on U.S. GAAP.

Subsequent Events - The Company has evaluated events and transactions subsequent to September 30, 2016, for potential recognition or disclosure.

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RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board ("FASB") issued 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 guidance 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. In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, which provides clarifying guidance in certain narrow areas and adds some practical expedients, but does not change the core revenue recognition principle in Topic 606. 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 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 ASU 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 amendments in this ASU require the exit price notion be used 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 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 ASU 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.

In February 2016, the 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 projected to increase our balance sheet by no more than 5% and not have a material impact on our capital ratios.

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In March 2016, the FASB issued ASU No. 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments. The ASU simplifies the embedded derivative analysis for debt instruments containing contingent call or put options by removing the requirement to assess whether a contingent event is related to interest rates or credit risks. 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, 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, the FASB issued ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The amendments in this update seek to simplify several aspects of the accounting for employee share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 will be effective for the Company for annual periods beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption of the update is permitted. The Company is currently evaluating early adoption of this ASU and the impact 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. The ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact of this ASU on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Receipts and Cash Payments, a consensus of the FASB's Emerging Issues Task Force. The ASU is intended to reduce diversity in practice in how certain transactions are presented and classified in the statement of cash flows. The standard will take effect for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The adoption of ASU No. 2016-15 is being reviewed for any material impact there may be on the Company's consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 - BUSINESS COMBINATION

On January 22, 2016, the Company's wholly-owned subsidiary, 1st Security Bank, completed the purchase of four branches ("Branch Purchase") from Bank of America, National Association ("Bank of America"). The Branch Purchase included four retail bank branches located in the communities of Port Angeles, Sequim, Port Townsend, and Hadlock, Washington.
In accordance with the Purchase and Assumption Agreement, dated as of September 1, 2015, between Bank of America and 1st Security Bank, 1st Security Bank acquired $186.4 million of deposits, a small portfolio of performing loans, two owned bank branches, three leases associated with the bank branches and parking facilities and certain other assets of the branches. As of September 30, 2016, approximately $171.0 million of the acquired deposits remain at 1st Security Bank.

In consideration of the purchased assets and transferred liabilities, 1st Security Bank paid (a) the unpaid principal balance and accrued interest of $419,000 for the loans acquired, (b) the net book value, or approximately $778,000, for the bank facilities and certain other assets associated with the acquired branches, and (c) a deposit premium of 2.50% on substantially all of the deposits assumed, which equated to approximately $4.8 million. The transaction was settled with Bank of America paying cash of $180.4 million to 1st Security Bank for the difference between these amounts and the total deposits assumed.

The Branch Purchase was accounted for under the acquisition method of accounting and accordingly, the assets and liabilities were recorded at their fair values on January 22, 2016, the date of acquisition. Determining the fair value of assets and liabilities is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values become available. During the second quarter of 2016, the Company completed a re-evaluation of the core deposit intangible because a portion of the core deposits were excluded from the original valuation. The updated valuation of the core deposit intangible increased the fair value adjustment by $100,000 to $2.2 million from $2.1 million resulting in a decrease of $100,000 to the fair value adjustment of goodwill. The impact to consolidated net income was an increase in the amortization of the core deposit intangible for the six months ended June 30, 2016 of $6,000 and was not considered material to the consolidated financial statements.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed at the date of acquisition:

January 22, 2016	Acquired Book Value	Fair Value Adjustments	Amount Recorded
Assets			
Cash and cash equivalents	$180,356	$ —	$180,356

Loans receivable	417	—		417
Premises and equipment, net	697	267	(1)	964
Accrued interest receivable	2	—		2
Core deposit intangible	—	2,239	(2)	2,239
Goodwill	—	2,312	(3)	2,312
Other assets	103	—		103
Total assets acquired	$181,575	$ 4,818		$186,393
Liabilities				
Deposits:				
Noninterest-bearing accounts	$79,966	$ —		$79,966
Interest-bearing accounts	106,398	—		106,398
Total deposits	186,364	—		186,364
Accrued interest payable	7	—		7
Other liabilities	22	—		22
Total liabilities assumed	$186,393	$ —		$186,393

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Explanation of Fair Value Adjustments

(1) The fair value adjustment represents the difference between the fair value of the acquired branches and the book value of the assets acquired. The Company utilized third-party valuations but did not receive appraisals to assist in the determination of fair value.
(2) The fair value adjustment represents the value of the core deposit base assumed in the Branch Purchase based on a study performed by an independent consulting firm. This amount was recorded by the Company as an identifiable intangible asset and will be amortized as an expense on an accelerated basis over the average life of the core deposit base, which is estimated to be nine years.
(3) The fair value adjustment represents the value of the goodwill calculated from the purchase based on the purchase price, less the fair value of assets acquired net of liabilities assumed.

Goodwill - The acquired goodwill represents the excess purchase price over the estimated fair value of the net assets acquired and was recorded at $2.3 million on January 22, 2016.

The table below summarizes the aggregate amount recognized for each major class of assets acquired and liabilities assumed by 1st Security Bank in the Branch Purchase on January 22, 2016:

	At January 22, 2016
Purchase price [1]	$ 6,015
Recognized amounts of identifiable assets acquired and (liabilities assumed), at fair value:	
Cash and cash equivalents	186,371
Acquired loans	417
Premises and equipment, net	964
Accrued interest receivable	2
Core deposit intangible	2,239
Other assets	103
Deposits	(186,364)
Accrued interest payable	(7)
Other liabilities	(22)
Total fair value of identifiable net assets	3,703
Goodwill	$ 2,312

(1) Purchase price includes premium paid on the deposits, the aggregate net book value of all assets acquired, and the unpaid principal and accrued interest on loans acquired.

Core deposit intangible

The core deposit intangible represents the fair value of the acquired core deposit base. The core deposit intangible will be amortized on an accelerated basis over approximately nine years. Total amortization expense was $140,000 and $382,000 for the three and nine months ended September 30, 2016, and none for the same periods in 2015. Amortization expense for core deposit intangible is expected to be as follows:

2016	$ 140
2017	400
2018	307
2019	235
2020	181
Thereafter	594
Total	$ 1,857

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NOTE 3 - SECURITIES AVAILABLE-FOR-SALE

The following tables present the amortized costs, unrealized gains, unrealized losses, and estimated fair values of securities available-for-sale at September 30, 2016 and December 31, 2015:

	September 30, 2016			
SECURITIES AVAILABLE-FOR-SALE	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Values
U.S. agency securities	$8,158	$ 115	$ —	$ 8,273
Municipal bonds	17,452	499	(2)	17,949
Corporate securities	7,664	44	(95)	7,613
U.S. Small Business Administration securities	5,863	147	—	6,010
Mortgage-backed securities	40,426	492	(1)	40,917
Total securities available-for-sale	$79,563	$ 1,297	$ (98)	$ 80,762

	December 31, 2015			
SECURITIES AVAILABLE-FOR-SALE	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Values
U.S. agency securities	$6,134	$ —	$ (99)	$ 6,035
Municipal bonds	18,531	373	(13)	18,891
Corporate securities	3,495	5	(67)	3,433
U.S. Small Business Administration securities	4,011	23	(11)	4,023
Mortgage-backed securities	22,926	72	(163)	22,835
Total securities available-for-sale	$55,097	$ 473	$ (353)	$ 55,217

Investment securities that were in an unrealized loss position at September 30, 2016 and December 31, 2015 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. Management considers that these securities are only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

	September 30, 2016					
	Less than 12 Months		12 Months or Longer		Total	
SECURITIES AVAILABLE-FOR-SALE	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Municipal bonds	$176	$ (2)	$—	$ —	$176	$ (2)
Corporate securities	965	(30)	1,435	(65)	2,400	(95)

Mortgage-backed securities	1,272	(1)	—	—	1,272	(1)
Total	$2,413	$ (33)	$1,435	$ (65)	$3,848	$ (98)

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	December 31, 2015					
	Less than 12 Months		12 Months or Longer		Total	
SECURITIES AVAILABLE-FOR-SALE	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. agency securities	$2,107	$ (31)	$3,928	$ (68)	$6,035	$ (99)
Municipal bonds	956	(1)	293	(12)	1,249	(13)
Corporate securities	994	(6)	1,439	(61)	2,433	(67)
U.S. Small Business Administration securities	990	(11)	—	—	990	(11)
Mortgage-backed securities	15,642	(112)	2,119	(51)	17,761	(163)
Total	$20,689	$ (161)	$7,779	$ (192)	$28,468	$ (353)

There were four investments with unrealized losses of less than one year, and two investments with unrealized losses of more than one year at September 30, 2016. There were 17 investments with unrealized losses of less than one year, and eight investments with unrealized losses of more than one year at December 31, 2015. The unrealized losses associated with these investments are believed to be caused by changes in market interest rates that are considered to be temporary and the Company does not intend to sell the securities, and it is not likely to be required to sell these securities prior to maturity. No other-than-temporary impairment was recorded for the nine months ended September 30, 2016 or for the year ended December 31, 2015.

The contractual maturities of securities available-for-sale at September 30, 2016 and December 31, 2015 are listed below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay the obligations; therefore, these securities are classified separately with no specific maturity date.

	September 30, 2016		December 31, 2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. agency securities				
Due after one year through five years	$4,000	$4,003	$—	$—
Due after five years through ten years	4,158	4,270	6,134	6,035
Subtotal	8,158	8,273	6,134	6,035
Municipal bonds				
Due in one year or less	978	979	991	997
Due after one year through five years	5,578	5,718	3,904	3,954
Due after five years through ten years	8,499	8,784	7,807	7,981
Due after ten years	2,397	2,468	5,829	5,959
Subtotal	17,452	17,949	18,531	18,891

Corporate securities				
Due after one year through five years	5,669	5,700	1,500	1,490
Due after five years through ten years	1,995	1,913	1,995	1,943
Subtotal	7,664	7,613	3,495	3,433
U.S. Small Business Administration securities				
Due after five years through ten years	5,863	6,010	4,011	4,023
Mortgage-backed securities				
Federal National Mortgage Association (“FNMA”)	18,646	18,866	12,515	12,466
Federal Home Loan Mortgage Corporation (“FHLMC”)	14,069	14,239	4,524	4,501
Government National Mortgage Association (“GNMA”)	7,711	7,812	5,887	5,868
Subtotal	40,426	40,917	22,926	22,835
Total	$79,563	$80,762	$55,097	$55,217

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The proceeds and resulting gains and losses, computed using specific identification, from sales of securities available-for-sale for the three and nine months ended September 30, 2016 and 2015 were as follows:

	Three Months Ended September 30, 2016			Nine Months Ended September 30, 2016		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	$13,577	$ 149	$ (3)	$13,577	$ 149	$ (3)

	Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	$—	$ —	$ —	$4,178	$ 76	$ —

NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio at September 30, 2016 and December 31, 2015 was as follows:

	September 30, 2016	December 31, 2015
REAL ESTATE LOANS		
Commercial	$55,794	$50,034
Construction and development	90,201	80,806
Home equity	19,649	16,540
One-to-four-family (excludes loans held for sale)	116,886	102,921
Multi-family	33,988	22,223
Total real estate loans	316,518	272,524
CONSUMER LOANS		
Indirect home improvement	104,524	103,064
Solar	34,806	29,226
Marine	29,268	23,851
Other consumer	1,978	2,181
Total consumer loans	170,576	158,322
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	68,526	59,619
Warehouse lending	48,598	20,817
Total commercial business loans	117,124	80,436
Total loans receivable, gross	604,218	511,282

Allowance for loan losses	(9,586)	(7,785)
Deferred costs, fees, and discounts, net	(1,832)	(962)
Total loans receivable, net	$592,800	$502,535

The Company's lending business activity is concentrated in the greater Puget Sound area and one loan production office located in the Tri-Cities, Washington. Most of the Company's lending is to customers located in the greater Puget Sound area, however, indirect home improvement loans are originated through a network of home improvement contractors and dealers located throughout Washington, Oregon, Idaho, and California. The Company also originates solar loans through contractors and dealers in the state of California. Generally, loans are secured by real estate, liens on receivables and/or equipment, personal property, and/or deposit accounts. Rights to collateral vary and are legally documented to the extent practicable. Local economic conditions may affect borrowers' ability to meet the stated repayment terms.

The Company has defined its loan portfolio into three segments that reflect the structure of the lending function, the Company's strategic plan and the manner in which management monitors performance and credit quality. The three loan portfolio segments are: (a) Real Estate Loans, (b) Consumer Loans and (c) Commercial Business Loans. Each of these segments is disaggregated into classes based on the risk characteristics of the borrower and/or the collateral type securing the loan. The following is a summary of each of the Company's loan portfolio segments and classes:

Real Estate Loans

Commercial Lending. Loans originated by the Company primarily secured by income producing properties, including retail centers, warehouses, and office buildings located in our market areas.

Construction and Development Lending. Loans originated by the Company for the construction of, and secured by, commercial real estate, one-to-four-family, and multi-family residences and tracts of land for development that are not pre-sold.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences in our market areas.

One-to-Four-Family Real Estate Lending. Commercial and consumer loans originated by the Company secured by first mortgages on one-to-four-family residences in our market areas that the Company intends to hold (excludes loans held for sale).

Multi-Family Lending. Apartment term lending (five or more units) to current banking customers and community reinvestment loans for low to moderate income individuals in the Company's footprint.

Consumer Loans

Indirect Home Improvement. Fixture secured loans are originated by the Company for home improvement and are secured by the personal property installed in, on, or at the borrower's real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower's residence. These indirect home improvement loans include replacement windows, siding, roofing, and other home fixture installations.

Solar. Fixture secured loans are originated by the Company for home improvement and are secured by the personal property installed in, on, or at the borrower's real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower's residence.

Marine. Loans originated by the Company secured by boats to borrowers primarily located in its market areas.

Other Consumer. Loans originated by the Company, including automobiles, recreational vehicles, direct home improvement loans, loans on deposits, and other consumer loans, primarily consisting of personal lines of credit.

Commercial Business Loans

Commercial and Industrial Lending. Loans originated by the Company to local small and mid-sized businesses in our Puget Sound market area are secured primarily by accounts receivable, inventory, or personal property, plant and equipment. Commercial and industrial loans are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business.

Warehouse Lending. Loans originated by the Company's mortgage and construction warehouse lending program through

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which the Company funds third-party finance companies originating residential mortgage loans for sale into the secondary market and speculative construction loans for sale to single family households. These loans are secured by the notes and assigned deeds of trust associated with the residential mortgage and construction loans on properties primarily located in the Company’s market areas.

The following tables detail activity in the allowance for loan losses by loan categories at or for the three and nine months ended September 30, 2016 and 2015:

	At or For the Three Months Ended September 30, 2016				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$3,477	$2,039	$ 1,823	$ 1,612	$8,951
Provision for loan losses	242	1	252	105	600
Charge-offs	(65)	(232)	—	—	(297)
Recoveries	64	262	6	—	332
Net (charge-offs) recoveries	(1)	30	6	—	35
Ending balance	$3,718	$2,070	$ 2,081	$ 1,717	$9,586
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$ —	$ —	$—
Loans collectively evaluated for impairment	3,718	2,070	2,081	1,717	9,586
Ending balance	$3,718	$2,070	$ 2,081	$ 1,717	$9,586
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$209	$—	$ —	$ —	$209
Loans collectively evaluated for impairment	316,309	170,576	117,124	—	604,009
Ending balance	$316,518	$170,576	$ 117,124	$ —	$604,218

	At or For the Nine Months Ended September 30, 2016				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$2,874	$1,681	$ 1,396	$ 1,834	7,785
Provision for loan losses	794	519	604	(117)	1,800
Charge-offs	(65)	(801)	—	—	(866)
Recoveries	115	671	81	—	867
Net recoveries (charge-offs)	50	(130)	81	—	1
Ending balance	$3,718	$2,070	$ 2,081	$ 1,717	$9,586
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$ —	$ —	$—
Loans collectively evaluated for impairment	3,718	2,070	2,081	1,717	9,586
Ending balance	$3,718	$2,070	$ 2,081	$ 1,717	$9,586
LOANS RECEIVABLE					

Loans individually evaluated for impairment	$209	$—	$ —	$ —	$209
Loans collectively evaluated for impairment	316,309	170,576	117,124	—	604,009
Ending balance	$316,518	$170,576	$ 117,124	$ —	$604,218

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	At or For the Three Months Ended September 30, 2015				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$2,378	$1,444	$ 2,148	$ 957	$6,927
Provision for loan losses	328	225	(591)	638	600
Charge-offs	—	(350)	—	—	(350)
Recoveries	1	204	6	—	211
Net recoveries (charge-offs)	1	(146)	6	—	(139)
Ending balance	$2,707	$1,523	$ 1,563	$ 1,595	$7,388
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$ —	$ —	$—
Loans collectively evaluated for impairment	2,707	1,523	1,563	1,595	7,388
Ending balance	$2,707	$1,523	$ 1,563	$ 1,595	$7,388
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$736	$—	$ —	$ —	$736
Loans collectively evaluated for impairment	251,653	154,504	83,816	—	489,973
Ending balance	$252,389	$154,504	$ 83,816	$ —	$490,709

	At or For the Nine Months Ended September 30, 2015				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,872	$1,431	$ 1,184	$ 1,603	$6,090
Provision for loan losses	891	515	402	(8)	1,800
Charge-offs	(248)	(1,095)	(34)	—	(1,377)
Recoveries	192	672	11	—	875
Net charge-offs	(56)	(423)	(23)	—	(502)
Ending balance	$2,707	$1,523	$ 1,563	$ 1,595	$7,388
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$ —	$ —	$—
Loans collectively evaluated for impairment	2,707	1,523	1,563	1,595	7,388
Ending balance	$2,707	$1,523	$ 1,563	$ 1,595	$7,388
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$736	$—	$ —	$ —	$736
Loans collectively evaluated for impairment	251,653	154,504	83,816	—	489,973
Ending balance	$252,389	$154,504	$ 83,816	$ —	$490,709

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 obligations as they become due, or as required by regulatory authorities.

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The following tables provide information pertaining to the aging analysis of contractually past due loans and nonaccrual loans at September 30, 2016 and December 31, 2015:

	September 30, 2016						
REAL ESTATE LOANS	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non-Accrual
Commercial	$—	$—	$—	$—	$55,794	$55,794	$ —
Construction and development	—	—	—	—	90,201	90,201	—
Home equity	141	7	108	256	19,393	19,649	171
One-to-four-family	—	—	—	—	116,886	116,886	—
Multi-family	—	—	—	—	33,988	33,988	—
Total real estate loans	141	7	108	256	316,262	316,518	171
CONSUMER LOANS							
Indirect home improvement	307	185	183	675	103,849	104,524	387
Solar	59	71	—	130	34,676	34,806	36
Marine	—	—	—	—	29,268	29,268	—
Other consumer	5	1	—	6	1,972	1,978	—
Total consumer loans	371	257	183	811	169,765	170,576	423
COMMERCIAL BUSINESS LOANS							
Commercial and industrial	—	—	—	—	68,526	68,526	—
Warehouse lending	—	—	—	—	48,598	48,598	—
Total commercial business loans	—	—	—	—	117,124	117,124	—
Total loans	$512	$264	$291	$1,067	$603,151	$604,218	$ 594

	December 31, 2015						
REAL ESTATE LOANS	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Non-Accrual
Commercial	$—	$—	$—	$—	$50,034	$50,034	$ —
Construction and development	—	—	—	—	80,806	80,806	—
Home equity	157	20	47	224	16,316	16,540	47
One-to-four-family	48	—	525	573	102,348	102,921	525
Multi-family	—	—	—	—	22,223	22,223	—
Total real estate loans	205	20	572	797	271,727	272,524	572

CONSUMER LOANS							
Indirect home improvement	307	243	157	707	102,357	103,064	408
Solar	69	—	37	106	29,120	29,226	37
Marine	28	—	—	28	23,823	23,851	—
Other consumer	—	—	—	—	2,181	2,181	—
Total consumer loans	404	243	194	841	157,481	158,322	445
COMMERCIAL BUSINESS LOANS							
Commercial and industrial	—	—	—	—	59,619	59,619	—
Warehouse lending	—	—	—	—	20,817	20,817	—
Total commercial business loans	—	—	—	—	80,436	80,436	—
Total loans	$609	$263	$766	$1,638	$509,644	$511,282	$ 1,017

There were no loans 90 days or more past due and still accruing at September 30, 2016 and December 31, 2015.

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The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided at September 30, 2016 and December 31, 2015:

	September 30, 2016				
WITH NO RELATED ALLOWANCE RECORDED	Unpaid Principal Balance	Write-downs	Recorded Investment	Related Allowance	Adjusted Recorded Investment
Home equity	$152	$—	$ 152	$ —	$ 152
One-to-four-family	69	(12)	57	—	57
Total	$221	$(12)	$ 209	$ —	$ 209

	December 31, 2015				
WITH NO RELATED ALLOWANCE RECORDED	Unpaid Principal Balance	Write-downs	Recorded Investment	Related Allowance	Adjusted Recorded Investment
One-to-four-family	$801	$(67)	$ 734	$ —	$ 734

The following tables present the average recorded investment in loans individually evaluated for impairment and the interest income recognized and received for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended			
	September 30, 2016		September 30, 2015	
WITH NO RELATED ALLOWANCE RECORDED	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$—	$ —	$363	$ 38
Home equity	152	—	33	2
One-to-four-family	58	1	736	1
Total	$210	$ 1	$1,132	$ 41

	Nine Months Ended			
	September 30, 2016		September 30, 2015	
WITH NO RELATED ALLOWANCE RECORDED	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial	$—	$ —	$734	$ 76
Home equity	154	2	64	7
One-to-four-family	58	2	778	26

	212	4	1,576	109
WITH AN ALLOWANCE RECORDED				
Commercial and industrial	—	—	16	—
Total	$212	$ 4	$1,592	$ 109

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Credit Quality Indicators

As part of the Company’s on-going monitoring of credit quality of the loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grading of loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in the Company’s markets.

The Company utilizes a risk grading matrix to assign a risk grade to its real estate and commercial business loans. Loans are graded on a scale of 1 to 10, with loans in risk grades 1 to 6 considered “Pass” and loans in risk grades 7 to 10 are reported as classified loans in the Company’s allowance for loan loss analysis.

A description of the 10 risk grades is as follows:

- Grades 1 and 2 - These grades include loans to very high quality borrowers with excellent or desirable business credit.

- Grade 3 - This grade includes loans to borrowers of good business credit with moderate risk.

- Grades 4 and 5 - These grades include “Pass” grade loans to borrowers of average credit quality and risk.

- Grade 6 - This grade includes loans on management’s “Watch” list and is intended to be utilized on a temporary basis for “Pass” grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.

- Grade 7 - This grade is for “Other Assets Especially Mentioned” (“OAEM”) in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.

- Grade 8 - This grade includes “Substandard” loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.

- Grade 9 - This grade includes “Doubtful” loans in accordance with regulatory guidelines where a loss is highly probable.

- Grade 10 - This grade includes “Loss” loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged off.

Consumer, Home Equity and One-to-Four-Family Real Estate Loans

Homogeneous loans are risk rated based upon the FDIC’s Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement, solar, marine, other consumer, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded “Pass” and risk rated “4” or “5” internally. Loans that are past due more than 90 days are classified “Substandard” and risk rated “8” internally until the loan has demonstrated consistent performance, typically six months of contractual payments. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.

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The following tables summarize risk rated loan balances by category at September 30, 2016 and December 31, 2015:

	September 30, 2016						
REAL ESTATE LOANS	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
Commercial	$52,613	$3,181	$ —	$ —	$ —	$ —	$55,794
Construction and development	90,201	—	—	—	—	—	90,201
Home equity	19,478	—	—	171	—	—	19,649
One-to-four-family	116,886	—	—	—	—	—	116,886
Multi-family	33,988	—	—	—	—	—	33,988
Total real estate loans	313,166	3,181	—	171	—	—	316,518
CONSUMER LOANS							
Indirect home improvement	104,137	—	—	387	—	—	104,524
Solar	34,770	—	—	36	—	—	34,806
Marine	29,268	—	—	—	—	—	29,268
Other consumer	1,978	—	—	—	—	—	1,978
Total consumer loans	170,153	—	—	423	—	—	170,576
COMMERCIAL BUSINESS LOANS							
Commercial and industrial	64,889	515	—	3,122	—	—	68,526
Warehouse lending	48,598	—	—	—	—	—	48,598
Total commercial business loans	113,487	515	—	3,122	—	—	117,124
Total loans	$596,806	$3,696	$ —	$ 3,716	$ —	$ —	$604,218

	December 31, 2015						
REAL ESTATE LOANS	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
Commercial	$50,034	$—	$ —	$ —	$ —	$ —	$50,034
Construction and development	79,100	1,706	—	—	—	—	80,806
Home equity	16,493	—	—	47	—	—	16,540
One-to-four-family	102,396	—	—	525	—	—	102,921
Multi-family	22,223	—	—	—	—	—	22,223
Total real estate loans	270,246	1,706	—	572	—	—	272,524
CONSUMER LOANS							
Indirect home improvement	102,656	—	—	408	—	—	103,064
Solar	29,189	—	—	37	—	—	29,226
Marine	23,851	—	—	—	—	—	23,851
Other consumer	2,181	—	—	—	—	—	2,181
Total consumer loans	157,877	—	—	445	—	—	158,322
COMMERCIAL BUSINESS LOANS							

Commercial and industrial	54,977	2,352	335	1,955	—	—	59,619
Warehouse lending	20,817	—	—	—	—	—	20,817
Total commercial business loans	75,794	2,352	335	1,955	—	—	80,436
Total loans	$503,917	$4,058	$ 335	$ 2,972	$ —	$ —	$511,282

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Troubled Debt Restructured Loans

Troubled debt restructured ("TDR") loans are loans for which the Company, for economic or legal reasons related to the borrower's financial condition, has granted a significant concession to the borrower that it would otherwise not consider. The loan terms which have been modified or restructured due to a borrower's financial difficulty include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. TDR loans are considered impaired loans and are individually evaluated for impairment. TDR loans can be classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months in which case they are placed on accrual status. The Company had one TDR loan with a balance of $57,000 at September 30, 2016, which was still on accrual and included in impaired loans at September 30, 2016, and two TDR loans totaling $734,000 at December 31, 2015, of which one TDR loan with a balance of $525,000 was on non-accrual, and one TDR loan of $209,000 was still on accrual. The Company had no commitments to lend additional funds on these TDR loans at September 30, 2016.

The following table summarizes TDR loan balances at the dates indicated:

	September 30, 2016	December 31, 2015
TDR loans on accrual	$ 57	$ 209
TDR loans on non-accrual	—	525
Total TDR loan balances	$ 57	$ 734

For the three and nine months ended September 30, 2016 and 2015 there were no TDR loans that were modified in the previous 12 months that subsequently defaulted in the reporting period.

NOTE 5 - SERVICING RIGHTS

Loans serviced for others are not included on the Consolidated Balance Sheets. The unpaid principal balances of mortgage, commercial, and consumer loans serviced for others were $882.2 million and $636.1 million at September 30, 2016 and December 31, 2015, respectively and are carried at the lower of cost or market. At September 30, 2016 and December 31, 2015, mortgage, commercial, and consumer servicing rights' ("servicing rights") assets are recorded on the Consolidated Balance Sheets at a book value of $7.7 million and $5.8 million, respectively. The fair market value of the servicing rights' assets was $7.8 million and $6.8 million at September 30, 2016 and December 31, 2015, respectively.

The following tables summarize servicing rights activity for the three and nine months ended September 30, 2016 and 2015:

	At or For the Three Months Ended September 30,	
	2016	2015
Beginning balance	$6,751	$4,569
Additions	1,095	920
Servicing rights amortized	(408)	(263)
Recovery on servicing rights	216	—
Ending balance	$7,654	$5,226

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	At or For the Nine Months Ended September 30,	
	2016	2015
Beginning balance	$5,811	$3,061
Additions	2,927	2,823
Servicing rights amortized	(1,086)	(658)
Recovery on servicing rights	2	—
Ending balance	$7,654	$5,226

Fair value adjustments to mortgage, commercial, and consumer servicing rights were mainly due to market based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights.

The following provides valuation assumptions used in determining the fair value of mortgage servicing rights ("MSR") at the dates indicated:

	At September 30,	
Key assumptions:	2016	2015
Weighted average discount rate	9.5 %	8.5 %
Conditional prepayment rate ("CPR")	16.4 %	12.5 %
Weighted average life in years	5.2	6.4

Key economic assumptions and the sensitivity of the current fair value for single family mortgage servicing rights to immediate adverse changes in those assumptions at September 30, 2016 and December 31, 2015 were as follows:

	September 30, 2016	December 31, 2015
Aggregate portfolio principal balance	$877,427	$631,812
Weighted average rate of note	3.9 %	4.0 %

At September 30, 2016	Base	0.5% Adverse Rate Change	1.0% Adverse Rate Change
Conditional prepayment rate	16.4 %	25.3 %	35.2 %
Fair value MSR	$7,811	$6,044	$4,859

Percentage of MSR	0.9 %	0.7 %	0.6 %
Discount rate	9.5 %	10.0 %	10.5 %
Fair value MSR	$7,811	$7,685	$7,562
Percentage of MSR	0.9 %	0.9 %	0.9 %

At December 31, 2015	Base	0.5% Adverse Rate Change	1.0% Adverse Rate Change
Conditional prepayment rate	12.2 %	17.8 %	25.3 %
Fair value MSR	$6,813	$5,660	$4,557
Percentage of MSR	1.1 %	0.9 %	0.7 %
Discount rate	8.5 %	9.0 %	9.5 %
Fair value MSR	$6,813	$6,678	$6,548
Percentage of MSR	1.1 %	1.1 %	1.0 %

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The above tables show the sensitivity to market rate changes for the par rate coupon for a conventional one-to-four-family FNMA/FHLMC/GNMA serviced home loan. The above tables reference a 50 basis point and 100 basis point decrease in note rates.

These sensitivities are hypothetical and should be used with caution as the tables above demonstrate the Company's methodology for estimating the fair value of MSR is highly sensitive to changes in key assumptions. For example, actual prepayment experience may differ and any difference may have a material effect on MSR fair value. Changes in fair value resulting from changes in assumptions generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, in these tables, the effects of a variation in a particular assumption on the fair value of the MSR is calculated without changing any other assumption; in reality, changes in one factor may be associated with changes in another (for example, decreases in market interest rates may provide an incentive to refinance; however, this may also indicate a slowing economy and an increase in the unemployment rate, which reduces the number of borrowers who qualify for refinancing), which may magnify or counteract the sensitivities. Thus, any measurement of MSR fair value is limited by the conditions existing and assumptions made at a particular point in time. Those assumptions may not be appropriate if they are applied to a different point in time.

The Company recorded $534,000 and $343,000 of contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of mortgage, commercial and consumer loans for the three months ended September 30, 2016 and 2015, respectively, and $1.4 million and $857,000 for the nine months ended September 30, 2016 and 2015, respectively. The income, net of amortization, is reported in noninterest income.

NOTE 6 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters into contracts to sell forward To-Be-Announced ("TBA") mortgage-backed securities. These commitments and contracts are considered derivatives but have not been designated as hedging instruments. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes in the fair value of the derivatives reported in noninterest income. The Company recognizes all derivative instruments as either other assets or other liabilities on the Consolidated Balance Sheets and measures those instruments at fair value.

The following tables summarize the Company's derivative instruments at the dates indicated:

	September 30, 2016		
		Fair Value	
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	$65,259	$1,850	$ —
Mandatory and best effort forward commitments with investors	29,824	—	40
Forward TBA mortgage-backed securities	99,500	—	385

TBA mortgage-backed securities forward sales paired off with investors	30,000	—	189

	December 31, 2015		
		Fair Value	
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	$34,154	$698	$ —
Mandatory and best effort forward commitments with investors	24,135	74	—
Forward TBA mortgage-backed securities	49,000	3	—
TBA mortgage-backed securities forward sales paired off with investors	28,500	30	—

Changes in the fair value of the derivatives recognized in other noninterest income on the Consolidated Statements of Income and included in gain on sale of loans resulted in a net gain of $697,000 and a net loss of $346,000 for the three

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months ended September 30, 2016 and 2015, respectively, and a net gain of $1.7 million and $1.1 million for the nine months ended September 30, 2016 and 2015, respectively.

NOTE 7 - OTHER REAL ESTATE OWNED

There was no OREO activity for the three months ended September 30, 2016 and 2015. The following table presents the activity related to OREO for the nine months ended September 30, 2016 and 2015:

	At or For the Nine Months Ended September 30,	
	2016	2015
Beginning balance	$ —	$ —
Net loans transferred to OREO	525	—
Capitalized costs	7	—
Gross proceeds from sale of OREO	(682)	—
Gain on sale of OREO	150	—
Ending balance	$ —	$ —

There were no OREO properties at September 30, 2016 and 2015. For the three months ended September 30, 2016 and 2015, the Company recorded no net gain or loss on the disposals of OREO, respectively. There were no holding costs associated with OREO for the three and nine months ended September 30, 2016 and 2015.

NOTE 8 - DEPOSITS

Deposits are summarized as follows at September 30, 2016 and December 31, 2015:

	September 30, 2016[3]	December 31, 2015
Noninterest-bearing checking	$ 143,251	$ 66,676
Interest-bearing checking	63,682	34,098
Savings	50,348	30,126
Money market	238,321	159,605
Certificates of deposit less than $100,000[1]	93,953	65,175
Certificates of deposit of $100,000 through $250,000	76,855	91,317
Certificates of deposit of $250,000 and over[2]	26,910	32,610

Escrow accounts related to mortgages serviced	9,844	5,571
Total	$ 703,164	$ 485,178

(1) Includes $47.1 million of brokered deposits at September 30, 2016 and $27.9 million at December 31, 2015.
(2) Time deposits that meet or exceed the FDIC insurance limit.
(3) Includes $171.0 million of deposits acquired in the Branch Purchase.

Scheduled maturities of time deposits at September 30, 2016 for future periods ending are as follows:

	At September 30, 2016
2016	$ 21,580
2017	76,878
2018	54,256
2019	17,151
2020	13,625
Thereafter	14,228
Total	$ 197,718

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The Bank pledged 13 securities held at the FHLB of Des Moines with a fair value of $15.7 million to secure Washington State public deposits of $6.6 million with a $746,000 collateral requirement by the Washington Public Deposit Protection Commission at September 30, 2016.

Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances at September 30, 2016 and December 31, 2015 were $12.6 million and $3.0 million, respectively, and were in compliance with Federal Reserve regulations.

Interest expense by deposit category for the three and nine months ended September 30, 2016 and 2015 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest-bearing checking	$7	$8	$20	$21
Savings and money market	257	262	757	760
Certificates of deposit	544	596	1,634	1,644
Total	$808	$866	$2,411	$2,425

NOTE 9 - COMMITMENTS AND CONTINGENCIES

Commitments - The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the balance sheet.

The Company’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The following table provides a summary of the Company’s commitments at September 30, 2016 and December 31, 2015:

COMMITMENTS TO EXTEND CREDIT	September 30,	December 31,
REAL ESTATE LOANS	2016	2015

Commercial	$ 232	$ 1,988
Construction and development	58,279	44,109
One-to-four-family (includes held for sale)	134,454	76,013
Home equity	25,023	18,089
Multi-family	425	429
Total real estate loans	218,413	140,628
CONSUMER LOANS	8,490	5,754
COMMERCIAL BUSINESS LOANS		
Commercial and industrial	33,233	39,537
Warehouse lending	34,402	27,601
Total commercial business loans	67,635	67,138
Total commitments to extend credit	$ 294,538	$ 213,520

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the amount of the total commitments do not necessarily represent future cash requirements. The Company evaluates each customer’s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon an extension of credit, is based on management’s credit evaluation of the party. Collateral held varies, but may include

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accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of $166,000 at September 30, 2016 and $147,000 at December 31, 2015. One-to-four-family commitments included in the table above are accounted for as fair value derivatives and do not carry an associated loss reserve.

The Company has entered into a severance agreement with its Chief Executive Officer. The severance agreement, subject to certain requirements, generally includes a lump sum payment to the Chief Executive Officer equal to 24 months of base compensation in the event his employment is involuntarily terminated, other than for cause or the executive terminates his employment with good reason, as defined in the severance agreement.

The Company has entered into change of control agreements with its Chief Financial Officer, Chief Operating Officer, Chief Lending Officer, and two Executive Vice Presidents of Home Lending. The change of control agreements, subject to certain requirements, generally remain in effect until canceled by either party upon at least 24 months prior written notice. Under the change of control agreements the executive generally will be entitled to a change of control payment from the Company if the executive is involuntarily terminated within six months preceding or 12 months after a change in control (as defined in the change of control agreements). In such an event, the executives would each be entitled to receive a cash payment in an amount equal to 12 months of their then current salary, subject to certain requirements in the change of control agreements.

Because of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position. The Company had no material pending legal actions at September 30, 2016.

Contingent liabilities for loans held for sale - In the ordinary course of business, the Company sells loans without recourse that may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payoff, early payment defaults, breach of representation or warranty, servicing errors, and/or fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded reserves of $825,000 and $561,000 to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at September 30, 2016 and December 31, 2015, respectively, which is included in other liabilities in the Consolidated Balance Sheets.

NOTE 10 - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. Consequently, the fair value of the Company’s consolidated financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate environment and more likely to prepay in a falling interest rate environment. Conversely, depositors who are receiving fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans, and deposits, and by investing in securities with terms that mitigate the Company’s overall interest rate risk.

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Accounting guidance regarding fair value measurements defines fair value and establishes a framework for measuring fair value in accordance with U.S. GAAP. Fair value is the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The following definitions describe the levels of inputs that may be used to measure fair value:

Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Determination of Fair Market Values:

Securities - Securities available-for-sale are recorded at fair value on a recurring basis. The fair value of investments and mortgage-backed securities are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid, and other market information, and for structured securities, cash flow, and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are also used to assess the impact of changes in interest rates and to develop prepayment scenarios. Transfers between the fair value hierarchy are determined through the third-party service provider which, from time to time will transfer between levels based on market conditions per the related security. All models and processes used, take into account market convention (Level 2).

Mortgage Loans Held for Sale - The fair value of loans held for sale reflects the value of commitments with investors and/or the relative price as delivered into a TBA mortgage-backed security (Level 2).

Derivative Instruments - The fair value of the interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. TBA mortgage-backed securities are fair valued on similar contracts in active markets (Level 2) while locks and forwards with customers and investors are valued using similar contracts in the market and changes in the market interest rates (Levels 2 and 3).

Impaired Loans - Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management’s assumptions (Level 3).

The following tables present securities available-for-sale measured at fair value on a recurring basis at September 30, 2016 and December 31, 2015:

	Securities Available-for-Sale			
At September 30, 2016	Level 1	Level 2	Level 3	Total
U.S. agency securities	$ —	$ 8,273	$ —	$ 8,273
Municipal bonds	—	17,949	—	17,949
Corporate securities	—	7,613	—	7,613
U.S. Small Business Administration securities	—	6,010	—	6,010
Mortgage-backed securities	—	40,917	—	40,917
Total	$ —	$ 80,762	$ —	$ 80,762

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	Securities Available-for-Sale			
At December 31, 2015	Level 1	Level 2	Level 3	Total
U.S. agency securities	$ —	$ 6,035	$ —	$ 6,035
Municipal bonds	—	18,891	—	18,891
Corporate securities	—	3,433	—	3,433
U.S. Small Business Administration securities	—	4,023	—	4,023
Mortgage-backed securities	—	22,835	—	22,835
Total	$ —	$ 55,217	$ —	$ 55,217

The following table presents mortgage loans held for sale measured at fair value on a recurring basis at September 30, 2016 and December 31, 2015:

	Mortgage Loans Held for Sale			
	Level 1	Level 2	Level 3	Total
September 30, 2016	$ —	$ 77,129	$ —	$ 77,129
December 31, 2015	$ —	$ 44,925	$ —	$ 44,925

The following tables present the fair value of interest rate lock commitments with customers, individual forward sale commitments with investors, and paired off commitments with investors measured at their fair value on a recurring basis at September 30, 2016 and December 31, 2015:

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
September 30, 2016	$ —	$ —	$ 1,850	$ 1,850
December 31, 2015	$ —	$ —	$ 698	$ 698

	Individual Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
September 30, 2016	$ —	$ (385)	$ (40)	$ (425)
December 31, 2015	$ —	$ 3	$ 74	$ 77

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
September 30, 2016	$—	$(189)	$ —	$(189)
December 31, 2015	$—	$30	$ —	$30

The following table presents impaired loans measured at fair value on a nonrecurring basis for which a nonrecurring change in fair value has been recorded during the reporting period. The amounts disclosed below represent the fair values at the time the nonrecurring fair value measurements were made, and not necessarily the fair value as of the dates reported upon.

	Impaired Loans			
	Level 1	Level 2	Level 3	Total
September 30, 2016	$—	$ —	$209	$209
December 31, 2015	$—	$ —	$734	$734

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Quantitative Information about Level 3 Fair Value Measurements - Shown below is the fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at September 30, 2016 table:

Level 3 Fair Value Instrument	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average
RECURRING				
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99%	93.4%
Individual forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	93.4%
NONRECURRING				
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0% - 18.0%	0.0%

An increase in the pull-through rate utilized in the fair value measurement of the interest rate lock commitments with customers and forward sale commitments with investors will result in positive fair value adjustments (and an increase in the fair value measurement). Conversely, a decrease in the pull-through rate will result in a negative fair value adjustment (and a decrease in the fair value measurement).

The following tables provide a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine months ended September 30, 2016 and 2015:

Three Months Ended September 30,	Beginning Balance	Purchases and Issuances	Sales and Settlements	Ending Balance	Net change in fair value for gains/(losses) relating to items held at end of period
2016					
Interest rate lock commitments with customers	$ 2,058	$ 5,763	$ (5,971)	$ 1,850	$ (208)
Individual forward sale commitments with investors	(3)	(60)	23	(40)	(37)
2015					
Interest rate lock commitments with customers	$ 934	$ 2,720	$ (2,797)	$ 857	$ (77)
Individual forward sale commitments with investors	110	(66)	(6)	38	(72)

Nine Months Ended September 30,	Beginning Balance	Purchases and Issuances	Sales and Settlements	Ending Balance	Net change in fair value for gains/(losses) relating to

					items held at end of period
2016					
Interest rate lock commitments with customers	$ 698	$ 14,039	$ (12,887)	$ 1,850	$ 1,152
Individual forward sale commitments with investors	74	(267)	153	(40)	(114)
2015					
Interest rate lock commitments with customers	$ 396	$ 8,683	$ (8,222)	$ 857	$ 461
Individual forward sale commitments with investors	12	21	5	38	26

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Gains (losses) on interest rate lock commitments carried at fair value are recorded in other noninterest income. Gains (losses) on forward sale commitments with investors carried at fair value are recorded within other noninterest income.

Fair Values of Financial Instruments - The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in these financial statements:

Cash, and Cash Equivalents and Certificates of Deposit at Other Financial Institutions - The carrying amounts of cash and short-term instruments approximates their fair value (Level 1).

Federal Home Loan Bank stock - The par value of FHLB stock approximates its fair value (Level 2).

Accrued Interest - The carrying amounts of accrued interest approximates its fair value (Level 2).

Loans Receivable, Net - For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers or similar credit quality (Level 3).

Servicing Rights - The fair value of mortgage, commercial and consumer servicing rights are estimated using net present value of expected cash flows using a third party model that incorporates assumptions used in the industry to value such rights, adjusted for factors such as weighted average prepayments speeds based on historical information, where appropriate (Level 3).

Deposits - The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation on interest rates currently offered on similar certificates (Level 2).

Borrowings - The carrying amounts of advances maturing within 90 days approximate their fair values. The fair values of long-term advances are estimated using discounted cash flow analyses based on the Bank’s current incremental borrowing rates for similar types of borrowing arrangements (Level 2).

Subordinated Note - The fair value of the Subordinated Note is based upon the average yield of debt issuances in the third quarter of 2016 for similarly sized issuances (Level 2).

Off-Balance Sheet Instruments - The fair value of commitments to extend credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the customers. The majority of the Company’s off-balance sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a distinguishable fair value. The fair value of loan lock commitments with customers and investors reflect an estimate of value based upon the interest rate lock date, the expected pull through percentage for the commitment, and the interest rate at year end (Levels 2 and 3).

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The following table provides estimated fair values of the Company's financial instruments at September 30, 2016 and December 31, 2015:

	September 30, 2016		December 31, 2015	
Financial Assets	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Level 1 inputs:				
Cash and cash equivalents	$16,513	$16,513	$24,455	$24,455
Certificates of deposit at other financial institutions	14,009	14,009	12,421	12,421
Level 2 inputs:				
Securities available-for-sale, at fair value	80,762	80,762	55,217	55,217
Loans held for sale, at fair value	77,129	77,129	44,925	44,925
FHLB stock, at cost	2,004	2,004	4,551	4,551
Accrued interest receivable	2,557	2,557	2,107	2,107
Individual forward sale commitments with investors	—	—	3	3
Paired off commitments with investors	—	—	30	30
Level 3 inputs:				
Loans receivable, net	592,800	621,772	502,535	566,209
Servicing rights, held at lower of cost or fair value	7,654	7,816	5,811	6,848
Fair value interest rate locks with customers	1,850	1,850	698	698
Individual forward sale commitments with investors	—	—	74	74
Financial Liabilities				
Level 2 inputs:				
Deposits	703,164	710,140	485,178	494,871
Borrowings	21,030	21,104	98,769	98,739
Subordinated note	10,000	9,550	10,000	9,550
Accrued interest payable	191	191	22	22
Individual forward sale commitments with investors	385	385	—	—
Paired off commitments with investors	189	189	—	—
Level 3 inputs:				
Individual forward sale commitments with investors	40	40	—	—

NOTE 11 - EMPLOYEE BENEFITS

Employee Stock Ownership Plan

On January 1, 2012, the Company established an ESOP for eligible employees of the Company and the Bank. Employees of the Company and the Bank who have been credited with at least 1,000 hours of service during a

12-month period are eligible to participate in the ESOP.

The ESOP borrowed $2.6 million from FS Bancorp, Inc. and used those funds to acquire 259,210 shares of FS Bancorp, Inc. common stock in the open market at an average price of $10.17 per share during the second half of 2012. It is anticipated that the Bank will make contributions to the ESOP in amounts necessary to amortize the ESOP loan payable to FS Bancorp, Inc. over a period of 10 years, bearing interest at 2.30%. Intercompany expenses associated with the ESOP are eliminated in consolidation. Shares purchased by the ESOP with the loan proceeds are held in a suspense account and allocated to ESOP participants on a pro rata basis as principal and interest payments are made by the ESOP to FS Bancorp, Inc. The loan is secured by shares purchased with the loan proceeds and will be repaid by the ESOP with

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funds from the Bank's discretionary contributions to the ESOP and earnings on the ESOP assets. Payments of principal and interest are due annually on December 31, the Company's fiscal year end. On December 31, 2015, the ESOP paid the fourth annual installment of principal in the amount of $251,000, plus accrued interest of $44,000 pursuant to the ESOP loan agreement.

As shares are committed to be released from collateral, the Company reports compensation expense equal to the average daily market prices of the shares at September 30, 2016 for the prior 90 days. These shares become outstanding for earnings per share computations. The compensation expense is accrued monthly throughout the year. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense related to the ESOP was $204,000 and $148,000 for the three months ended September 30, 2016 and 2015, respectively, and $529,000 and $408,000 for the nine months ended September 30, 2016 and 2015, respectively.

Shares held by the ESOP at September 30, 2016 were as follows (shown as actual):

	Balances
Allocated shares	102,359
Committed to be released shares	19,441
Unallocated shares	136,085
Total ESOP shares	257,885
Fair value of unallocated shares (in thousands)	$ 3,703

NOTE 12 - EARNINGS PER SHARE

Basic earnings per share are computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. For earnings per share calculations, the ESOP shares committed to be released are included as outstanding shares for both basic and diluted earnings per share.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the three and nine months ended September 30, 2016 and 2015:

	At or For the Three Months Ended September 30,		At or For the Nine Months Ended September 30,	
Numerator:	2016	2015	2016	2015
Net income (in thousands)	$3,457	$ 1,995	$7,953	$ 6,859

Denominator:				
Basic weighted average common shares outstanding	2,851,147	2,984,164	2,901,572	2,967,284
Dilutive shares	87,292	55,843	84,102	42,108
Diluted weighted average common shares outstanding	2,938,439	3,040,007	2,985,674	3,009,392
Basic earnings per share	$ 1.21	$ 0.67	$ 2.74	$ 2.31
Diluted earnings per share	$ 1.18	$ 0.66	$ 2.66	$ 2.28

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NOTE 13 - STOCK-BASED COMPENSATION
Stock Options and Restricted Stock

In September 2013, the shareholders of FS Bancorp, Inc. approved the FS Bancorp, Inc. 2013 Equity Incentive Plan ("Plan"). The Plan provides for the grant of stock options and restricted stock awards.

Total share-based compensation expense for the Plan was $195,000 and $588,000 for the three and nine months ended September 30, 2016, respectively, and $186,000 and $560,000 for the three and nine months ended September 30, 2015, respectively.

Stock Options

The Plan authorizes the grant of stock options totaling 324,013 shares to Company directors and employees. Option awards were granted with an exercise price equal to the market price of FS Bancorp's common stock at the grant date, May 8, 2014, of $16.89 per share. These option awards were granted as non-qualified stock options, having 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 10 years after the grant date or sooner in the event of the award recipient's termination of service with the Company or the Bank.

The fair value of each option award is estimated on the grant date using a Black-Scholes Option pricing 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 Company became a publicly held company in July 2012, therefore historical data was not available to calculate the volatility for FS Bancorp stock. Given this limitation, management utilized a proxy to determine the expected volatility of FS Bancorp's stock. The proxy chosen was the NASDAQ Bank Index, or NASDAQ Bank (NASDAQ symbol: BANK). This index provides the volatility of the banking sector for NASDAQ traded banks. The majority of smaller banks are traded on the NASDAQ given the costs and daily interaction required with trading on the New York Stock Exchange. The Company utilized the comparable Treasury rate for the discount rate associated with the stock options granted. The Company elected to use Staff Accounting Bulletin 107, simplified expected term calculation for 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 6.5 years.
The following table presents a summary of the Company's stock option plan awards during the nine months ended September 30, 2016 (shown as actual):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2016	306,900	$ 16.89	8.36	$2,794,570
Granted	—	—	—	—

Less exercised	9,300	16.89	—	81,942
Forfeited or expired	—	—	—	—
Outstanding at September 30, 2016	297,600	$ 16.89	7.61	$3,660,480
Expected to vest, assuming a 0.31% annual forfeiture rate	296,655	$ 16.89	7.61	$3,648,855
Exercisable at September 30, 2016	107,400	$ 16.89	7.61	$1,321,020

At September 30, 2016, there was $597,000 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 2.6 years.

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Restricted Stock Awards

The Plan authorizes the grant of restricted stock awards totaling 129,605 shares to Company directors and employees, and all but 4,500 shares were granted on May 8, 2014 at a grant date fair value of $16.89 per share. The remaining 4,500 restricted stock awards were granted January 1, 2016 at a grant date fair value of $26.00 per share. Compensation expense is recognized over the vesting period of the awards based on the fair value of the restricted stock. The restricted stock awards' fair value is equal to the value on the grant date. Shares awarded as restricted stock vest ratably over a three-year period for directors and a five-year period for employees, beginning at the grant date. Any unexercised restricted stock awards will expire after vesting or sooner in the event of the award recipient's termination of service with the Company or the Bank.
The following table presents a summary of the Company's nonvested awards during the nine months ended September 30, 2016 (shown as actual):

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2016	94,684	$ 16.89	$ 1,599,212
Granted	4,500	26.00	117,000
Less vested	30,421	16.89	513,811
Forfeited or expired	—	—	—
Nonvested at September 30, 2016	68,763	$ 17.49	$ 1,202,401

At September 30, 2016, there was $970,000 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 2.3 years.

NOTE 14 - REGULATORY CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 total capital (as defined) and common equity Tier 1 ("CET 1") capital to risk-weighted assets (as defined).

The Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below to be categorized as well capitalized. At September 30, 2016 and December 31, 2015, the Bank was categorized as well capitalized under applicable regulatory requirements. There are no conditions or events since that notification that management believes have changed the Bank’s category.

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The following tables compare the Bank's actual capital amounts and ratios at September 30, 2016 and December 31, 2015 to their minimum regulatory capital requirements and well capitalized regulatory capital at those dates (dollars in thousands):

Bank Only	Actual		For Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
At September 30, 2016	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital (to risk-weighted assets)	$91,077	13.46%	$54,127	8.00%	$67,659	10.00%
Tier 1 risk-based capital (to risk-weighted assets)	$82,604	12.21%	$40,595	6.00%	$54,127	8.00 %
Tier 1 leverage capital (to average assets)	$82,604	10.33%	$31,994	4.00%	$39,992	5.00 %
CET 1 capital (to risk-weighted assets)	$82,604	12.21%	$30,446	4.50%	$43,978	6.50 %
At December 31, 2015						
Total risk-based capital (to risk-weighted assets)	$85,570	15.51%	$44,132	8.00%	$55,164	10.00%
Tier 1 risk-based capital (to risk-weighted assets)	$78,662	14.26%	$33,099	6.00%	$44,132	8.00 %
Tier 1 leverage capital (to average assets)	$78,662	12.14%	$25,924	4.00%	$32,406	5.00 %
CET 1 capital (to risk-weighted assets)	$78,662	14.26%	$24,824	4.50%	$35,857	6.50 %

In addition to the minimum CET 1, Tier 1 and total capital ratios, the Bank has to maintain a capital conservation buffer consisting of additional CET 1 capital above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement began to be phased in starting in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented to an amount equal to 2.5% of risk-weighted assets in January 2019.

FS Bancorp, Inc. is a bank holding company subject to the capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. For a bank holding company with less than $1.0 billion in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If FS Bancorp, Inc. was subject to regulatory guidelines for bank holding companies with $1.0 billion or more in assets, at September 30, 2016, the Company would have exceeded all regulatory capital requirements. The regulatory capital ratios calculated for FS Bancorp, Inc. at September 30, 2016 were 9.4% for Tier 1 leverage-based capital, 11.1% for Tier 1 risk-based capital, 12.4% for total risk-based capital, and 11.1% for CET 1 capital ratio.

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

Forward-Looking Statements

This report may contain forward-looking statements, which can be identified by the use of words such as “believes,” “expects,” “anticipates,” “estimates,” or similar expressions. Forward-looking statements include, but are not limited to:

- statements of our goals, intentions, and expectations;
- statements regarding our business plans, prospects, growth, and operating strategies;
- statements regarding the quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values in our market area;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our mortgage banking operations, our warehouse lending, and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and expected cost savings and other benefits within the anticipated time frames or at all including in particular, our recent Branch Purchase;
- our ability to control operating costs and expenses;
- changes in consumer spending, borrowing, and savings habits;
- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, or increase capital requirements, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act, changes in regulation policies and principles, or the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;

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- costs and effects of litigation, including settlements and judgments;
- our ability to implement our branch expansion strategy;
- inability of key third-party vendors to perform their obligations to us; and
- other economic, competitive, governmental, regulatory, and technical factors affecting our operations, pricing, products, and services and other risks described elsewhere in this Form 10-Q and our other reports filed with the U.S. Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2015.

Any of the forward-looking statements made in this Form 10-Q and in other public statements may turn out to be wrong because of inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Forward-looking statements are based upon management's beliefs and assumptions at the time they are made. The Company undertakes no obligation to update or revise any forward-looking statement included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur and you should not put undue reliance on any forward-looking statements.

Overview

FS Bancorp, Inc. and its subsidiary bank, 1st Security Bank have been serving the Puget Sound area since 1936. Originally chartered as a credit union, previously known as Washington's Credit Union, the credit union served various select employment groups. On April 1, 2004, the credit union converted to a Washington state-chartered mutual savings bank. On July 9, 2012, the Bank converted from mutual to stock ownership and became the wholly owned subsidiary of FS Bancorp, Inc.

The Company is relationship-driven delivering banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities, and opened one loan production office located in the Tri-Cities, Washington during the fourth quarter of 2014. On January 22, 2016, the Company completed the previously announced Branch Purchase from Bank of America, N.A. and acquired $186.4 million in deposits and $419,000 in loans based on January 22, 2016 financial information. The four branches are located in the communities of Port Angeles, Sequim, Port Townsend, and Hadlock, Washington. The Branch Purchase expanded our Puget Sound-focused retail footprint onto the Olympic Peninsula and provided an opportunity to extend our unique brand of community banking into those communities.

The Company also maintains its long-standing indirect consumer lending platform which operates throughout the West Coast. The Company emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Company is also actively involved in community activities and events within these market areas, which further strengthens our relationships within those markets.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. Our business plan remains as follows:

Growing and diversifying our loan portfolio;
Maintaining strong asset quality;
Emphasizing lower cost core deposits to reduce the costs of funding our loan growth;
Capturing our customers' full relationship by offering a wide range of products and services by leveraging our well-established involvement in our communities and by selectively emphasizing products and services designed to meet our customers' banking needs.

The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, commercial real estate mortgage loans, home loans, commercial business loans, and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans to finance window replacement, gutter replacement, siding replacement, solar panels, and other improvement renovations, represent the largest portion of the loan portfolio and have traditionally been the mainstay of our lending strategy. At

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September 30, 2016, consumer loans represented 28.2% of the Company's total gross loan portfolio, down from 31.0% at December 31, 2015, as real estate loan originations have increased at a faster pace than consumer loan originations during the nine months ended September 30, 2016.

Indirect home improvement lending is dependent on the Bank's relationships with home improvement contractors and dealers. The Company funded $18.4 million, or 1,197 loans during the quarter ended September 30, 2016, using its indirect home improvement contractor/dealer network located throughout Washington, Oregon, Idaho, and California with four contractors/dealers responsible for 48.4% of the funded loans dollar volume. The Company began originating consumer indirect loans during the fourth quarter of 2012 in the State of California and since the program's inception has originated $90.5 million. During the nine months ended September 30, 2016, the Company originated $16.1 million of consumer indirect loans in California, and at September 30, 2016, the Company had $34.7 million of consumer indirect loans, including $34.5 million of consumer solar loans outstanding that were originated in California. Management has established a concentration limit of no more than 100% of the Bank's total risk-based capital for loans originated in California. At September 30, 2016, the limit was $91.1 million.

The Company originates loans secured by first mortgages on one-to-four-family residences primarily in the market areas served by the Company. The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders, and from existing customers. Walk-in customers are also an important source of the Company's loan originations. The Company originated $584.1 million of one-to-four-family mortgages during the nine months ended as of September 30, 2016, of which $471.7 million were sold to investors. Of the loans sold to investors, $321.5 million were sold to the FNMA, FHLMC, FHLB, and/or GNMA with servicing rights retained for the purpose of developing these customer relationships. At September 30, 2016, held for investment one-to-four-family residential mortgage loans, which excludes loans held for sale of $77.1 million, totaled $116.9 million, or 19.4%, of the total gross loan portfolio.

Since 2012, the Company has had an emphasis on diversifying lending products by expanding commercial real estate, commercial business and residential lending, while maintaining the current size of the consumer loan portfolio. The Company's lending strategies are intended to take advantage of: (1) historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as an important funding source.

The Company generally underwrites the one-to-four-family loans based on the applicant's ability to repay. This includes employment and credit history and the appraised value of the subject property. The Company lends up to 100% of the lesser of the appraised value or purchase price for one-to-four-family first mortgage loans. For first mortgage loans with a loan-to-value ratio in excess of 80%, the Company generally requires either private mortgage insurance or government sponsored insurance in order to mitigate the higher risk level associated with higher loan-to-value loans. Fixed-rate loans secured by one-to-four-family residences have contractual maturities of up to 30 years and are generally fully amortizing, with payments due monthly. Adjustable-rate mortgage loans may pose different credit risks than fixed-rate loans, primarily because as interest rates increase, the borrower's payments rise, increasing the potential for default. Properties securing the one-to-four-family loans are appraised by independent fee appraisers who are selected in accordance with industry and regulatory standards. The Company requires borrowers to obtain title and hazard insurance, and flood insurance, if necessary. Loans are generally underwritten to the secondary market guidelines with additional requirements as determined by the internal underwriting department.

The Company is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs. Deposit flows are influenced by a number of factors, including interest rates paid on time deposits, other investments, account maturities, and the overall level of personal income and savings. Lending activities are influenced by the demand for funds, the number and quality of lenders, and regional economic cycles. Sources of funds for lending activities include primarily deposits, including brokered deposits, borrowings, payments on loans and income provided from operations.

The Company’s earnings are dependent upon net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings. Another significant influence on the Company's earnings is fee income from mortgage banking activities. The Company’s earnings are also affected by the provision for loan losses, service charges and fees, gains from sales of assets, operating expenses and income taxes.

Critical Accounting Policies and Estimates

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex, or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include the following:

Allowance for Loan Loss. The allowance for loan losses is the amount estimated by management as necessary to cover probable losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. A high degree of judgment is necessary when determining the amount of the allowance for loan losses. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions, and other factors related to the collectability of the loan portfolio.

Although the Company believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. As the Company adds new products to the loan portfolio and expands the Company's market area, management intends to enhance and adapt our methodology to keep pace with the size and complexity of the loan portfolio. Changes in any of the above factors could have a significant effect on the calculation of the allowance for loan losses in any given period. Management believes that its systematic methodology continues to be appropriate given our size and level of complexity.

Servicing Rights. Servicing assets are recognized as separate assets when rights are acquired through the purchase or through the sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses.

Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance to the extent that fair value is less than the capitalized amount. If the Company later determines that all or a portion of the impairment no longer exists, a reduction of the allowance may be recorded as a recovery and an increase to income. Capitalized servicing rights are stated separately on the Consolidated Balance Sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Derivative and Hedging Activity. ASC 815, “Derivatives and Hedging,” requires that derivatives of the Company be recorded in the consolidated financial statements at fair value. Management considers its accounting policy for derivatives to be a critical accounting policy because these instruments have certain interest rate risk characteristics that change in value based upon changes in the capital markets. The Company’s derivatives are primarily the result of its mortgage banking activities in the form of commitments to extend credit, commitments to sell loans, TBA MBS trades and option contracts to mitigate the risk of the commitments to extend credit. Estimates of the percentage of commitments to extend credit on loans to be held for sale that may not fund are based upon historical data and current market trends. The fair value adjustments of the derivatives are recorded in the Consolidated Statements of Income with offsets to other assets or other liabilities in the Consolidated Balance Sheets.

Income Taxes. Income taxes are reflected in the Company's consolidated financial statements to show the tax effects of the operations and transactions reported in the consolidated financial statements and consist of taxes currently payable plus deferred taxes. Accounting Standards Codification, ASC 740, "Accounting for Income Taxes," requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities. They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating the deferred tax asset, the Company is required to estimate income and taxes in the jurisdiction in which the Company operates. This process involves estimating the actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for loan losses, for tax and financial reporting purposes.

Deferred tax liabilities occur when taxable income is less than reported income on the income statements due to accounting valuation methods that differ from tax, as well as tax rate estimates and payments made quarterly and adjusted to actual at the end of the year. Deferred tax liabilities are temporary differences payable in future periods. The Company had a net deferred tax liability of $1.9 million, and $1.3 million, at September 30, 2016 and December 31, 2015, respectively.

Comparison of Financial Condition at September 30, 2016 and December 31, 2015

Assets. Total assets increased $149.9 million, or 22.1%, to $827.5 million at September 30, 2016, from $677.6 million at December 31, 2015, primarily as a result of a $90.3 million, or 18.0% increase in loans receivable, net, a $32.2 million, or 71.7% increase in loans held for sale, a $25.5 million, or 46.3% increase in securities available-for-sale, a $2.9 million, or 153.0% increase in other assets, a $2.3 million, or 100.0% increase in goodwill, a $1.9 million, or 100.0% increase in core deposit intangible, and a $1.8 million, or 31.7% increase in servicing rights, a $1.6 million, or 12.8% increase in certificates of deposit at other financial institutions, and a $1.2 million, or 8.8% increase in premises and equipment, partially offset by a $7.9 million, or 32.5% decrease in cash and cash equivalents, and a $2.5 million, or 56.0% decrease in FHLB stock, at cost. The increase in assets during the nine months ended September 30, 2016 was primarily funded by cash received from deposits acquired in the Branch Purchase.

Loans receivable, net increased $90.3 million, or 18.0%, to $592.8 million at September 30, 2016, from $502.5 million at December 31, 2015. The increase in loans receivable, net was primarily a result of increases in total real estate loans of $44.0 million including increases in all categories of real estate loans, as well as increases of $27.8 million in warehouse lending, $12.3 million in consumer loans, and $8.9 million in commercial and industrial loans.

Loans held for sale, consisting of one-to-four-family loans, increased by $32.2 million, or 71.7%, to $77.1 million at September 30, 2016, from $44.9 million at December 31, 2015 due to increased loan originations and the timing difference between loan fundings and loan sale settlements. The Company continues to expand its home lending operations by hiring additional lending staff and will continue selling one-to-four-family mortgage loans into the secondary market for asset/liability management purposes. During the quarter ended September 30, 2016, the Company sold $205.1 million of one-to-four-family mortgage loans to investors, compared to sales of $137.5 million for the same quarter one year ago.

One-to-four-family originations of loans held for sale, including loans brokered to other institutions, increased $67.5 million, or 40.8% to $232.9 million during the three months ended September 30, 2016, compared to $165.4 million for the three months ended September 30, 2015. The growth in originations was a result of increased purchase activity associated with the strong home purchase demand in the Pacific Northwest and the continued favorable market interest rates.

The allowance for loan losses at September 30, 2016 was $9.6 million, or 1.6% of gross loans receivable, excluding loans held for sale, compared to $7.8 million, or 1.5% of gross loans receivable, excluding loans held for sale, at December 31, 2015. Substandard loans increased $744,000, or 25.0%, to $3.7 million at September 30, 2016, compared to $3.0 million at December 31, 2015, primarily due to four commercial lines of credit totaling $1.2 million that were downgraded as a result of the financial performance of the borrowers. Non-performing loans, consisting of non-accruing loans, decreased $423,000 or 41.6%, to $594,000 at September 30, 2016, from $1.0 million at December 31, 2015. At September 30, 2016, non-performing loans consisted of $387,000 of indirect home improvement loans, $171,000 of home equity loans, and $36,000 of solar loans. Non-performing loans to total gross loans decreased to 0.1% at September 30, 2016, compared to 0.2% at December 31, 2015. The Company had no OREO at September 30, 2016 or at December 31, 2015. The Company had one TDR loan with a balance of $57,000 at September 30, 2016, which was performing in accordance with its modified terms, compared to two TDR loans totaling $734,000 at December 31, 2015, of which one TDR loan with a balance of $525,000 was on non-accrual, and the remaining TDR loan of $209,000 was performing in accordance with its modified terms at December 31, 2015.

Liabilities. Total liabilities increased $145.7 million, or 24.2%, to $747.9 million at September 30, 2016, from $602.2 million at December 31, 2015 due primarily to the Branch Purchase. Deposits increased $218.0 million, or 44.9%, to $703.2 million at September 30, 2016, from $485.2 million at December 31, 2015. Relationship-based transactional accounts (noninterest-bearing checking, interest-bearing checking, and escrow accounts) increased $110.4 million, or 103.8%, to $216.8 million at September 30, 2016, from $106.3 million at December 31, 2015, including $6.6 million in public funds acquired in the Branch Purchase. Money market and savings accounts increased $98.9 million, or 52.1%, to $288.7 million at September 30, 2016, from $189.7 million at December 31, 2015. Time deposits increased $8.6 million, or 4.6%, to $197.7 million at September 30, 2016, from $189.1 million at December 31, 2015. Non-retail certificates of deposit which includes brokered certificates of deposit, online certificates of deposit, and public funds increased $14.2 million, or 30.7% to $60.5 million at September 30, 2016, compared to $46.3 million at December 31, 2015. Management remains focused on growth in lower cost relationship-based deposits.

At September 30, 2016, total debt was $30.9 million consisting of borrowings of $21.0 million and a subordinated note, net of $9.8 million. Borrowings decreased $77.7 million, or 78.7%, to $21.0 million at September 30, 2016, from $98.8 million at December 31, 2015, primarily due to the cash received in the Branch Purchase being utilized to repay FHLB advances.

Stockholders’ Equity. Total stockholders’ equity increased to $79.6 million at September 30, 2016, from $75.3 million at December 31, 2015. The increase in stockholders’ equity during the nine months ended September 30, 2016, was primarily related to net income of $8.0 million, and an increase of $695,000 in other comprehensive income (representing unrealized gains in our investment portfolio), primarily offset by common stock repurchases of $4.9 million. During the nine months ended September 30, 2016, the Company repurchased 198,000 shares of its common stock, of which 193,000 shares were purchased in accordance with the stock repurchase plan at an average price per share of $24.79. The Company’s stock repurchase plan announced on July 28, 2015, ended on August 31, 2016. Book value per common share was $27.89 at September 30, 2016, compared to $25.18 at December 31, 2015.

Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2016 and 2015

General. Net income for the three months ended September 30, 2016, increased $1.5 million, or 73.3%, to $3.5 million, from $2.0 million for the three months ended September 30, 2015. The increase in net income was primarily a result of a $2.9 million, or 65.6% increase in noninterest income, and a $1.7 million, or 21.3% increase in interest income, partially offset by a $2.5 million, or 31.7% increase in noninterest expense.

Net income for the nine months ended September 30, 2016, increased $1.1 million, or 15.9%, to $8.0 million, from $6.9 million for the nine months ended September 30, 2015. The increase in net income was primarily a result of a $4.8 million, or 21.2% increase in interest income, and a $4.4 million, or 32.1% increase in noninterest income, partially offset by a $7.1 million, or 32.9% increase in noninterest expense.

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The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities to calculate the comparison of results of operations for the three and nine months ended September 30, 2016 and 2015:

Average Balances	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
Assets	2016	2015	2016	2015
Loans receivable (1)	$643,989	$501,852	$600,343	$471,333
Securities available-for-sale, at fair value	83,643	50,518	80,214	47,416
Interest-bearing deposits and certificates of deposit at other financial institutions	36,744	17,060	74,573	17,000
Total interest-earning assets	764,376	569,430	755,130	535,749
Noninterest-earning assets (2)	39,081	26,847	35,026	26,064
Total assets	$803,457	$596,277	$790,156	$561,813
Liabilities and stockholders' equity				
Interest-bearing accounts	$532,069	$417,798	$517,625	$392,141
Borrowings	20,239	28,232	28,660	29,105
Subordinated note	9,817	—	9,812	—
Total interest-bearing liabilities	562,125	446,030	556,097	421,246
Noninterest-bearing accounts	153,209	71,815	147,848	65,029
Other noninterest-bearing liabilities	12,048	7,620	11,222	7,011
Stockholders' equity	76,075	70,812	74,989	68,527
Total liabilities and stockholders' equity	$803,457	$596,277	$790,156	$561,813

(1) Includes loans held for sale
(2) Includes BOLI, goodwill, and CDI

Net Interest Income. Net interest income increased $1.6 million, or 22.6%, to $8.8 million for the three months ended September 30, 2016, from $7.1 million for the three months ended September 30, 2015. The increase in net interest income was attributable to a $1.5 million, or 19.5% increase in loans receivable interest income, primarily due to an increase in the average loans receivable balance, and a $209,000, or 63.5% increase in interest and dividends on investment securities, cash and cash equivalents, and interest-bearing deposits at other financial institutions, partially offset by a $107,000, or 11.6% increase in total interest expense, primarily due to the addition of the subordinated note interest expense of $171,000.

Net interest income increased $4.4 million, or 21.5%, to $24.7 million for the nine months ended September 30, 2016, from $20.3 million for the nine months ended September 30, 2015. The increase in net interest income was attributable to a $4.0 million, or 18.0% increase in loans receivable interest income, primarily due to an increase in the average loans receivable balance, and an $877,000, or 100.3% increase in interest and dividends on investment securities, cash and cash equivalents, and interest-bearing deposits at other financial institutions, partially offset by a $480,000, or 18.3% increase in interest expense, primarily due to the addition of the subordinated note interest expense of $512,000.

The net interest margin ("NIM") decreased 42 basis points to 4.55% for the three months ended September 30, 2016, from 4.97% for the three months ended September 30, 2015, and decreased 70 basis points to 4.36% for the nine months ended September 30, 2016, from 5.06% for the same period of the prior year. The decreased NIM reflects increased balances in overnight cash balances invested at the overnight Fed Funds rate, and growth in lower yielding loan and investment assets. Our strategy to increase the loan portfolio through diversified lending channels has pressured the NIM as the increase in lower yielding real estate and commercial business loans has offset the increase in higher yielding consumer loan products. As a percentage, consumer loans to total gross loans were 28.2% at September 30, 2016, compared to 31.5% at September 30, 2015. The average cost of funds decreased 14 basis points to 0.57% for the three months ended September 30, 2016, from 0.71% for the three months ended September 30, 2015, and a 13 basis points decrease in the cost of funds to 0.59% for the nine months ended September 30, 2016, from 0.72% for the same period in the prior year. The decrease primarily reflects the growth of relatively low cost transactional non-maturity deposits acquired through the Branch Purchase and the decline in the percentage of higher cost certificates of deposit to total deposits over the last year. Management remains focused on matching deposit duration with the duration of earning assets where appropriate.

Interest Income. Interest income for the three months ended September 30, 2016, increased $1.7 million, or 21.3%, to $9.8 million, from $8.1 million for the three months ended September 30, 2015. The increase during the period was primarily attributable to the increase in the average balance of loans receivable to $644.0 million for the three months ended September 30, 2016, compared to $501.9 million for the three months ended September 30, 2015. The average yield on interest-earning assets decreased 52 basis points to 5.09% for the three months ended September 30, 2016, compared to 5.61% for the three months ended September 30, 2015.

Interest income for the nine months ended September 30, 2016, increased $4.8 million, or 21.2%, to $27.8 million, from $22.9 million for the nine months ended September 30, 2015. The increase during the period was primarily attributable to the increase in the average balance of loans receivable to $600.3 million for the nine months ended September 30, 2016, compared to $471.3 million for the nine months ended September 30, 2015. The average yield on interest-earning assets decreased 81 basis points to 4.91% for the nine months ended September 30, 2016, compared to 5.72% for the nine months ended September 30, 2015.

Interest Expense. Interest expense increased $107,000, or 11.6%, to $1.0 million for the three months ended September 30, 2016, from $922,000 for the same period of the prior year. The increase during the period was primarily attributable to the $116.1 million, or 26.0% increase in the average balance of interest-bearing liabilities to $562.1 million for the quarter ended September 30, 2016, from $446.0 million for the quarter ended September 30, 2015. The average cost of funds decreased 14 basis point to 0.57% for the three months ended September 30, 2016, compared to 0.71% for the three months ended September 30, 2015. The average cost of deposits decreased 22 basis points to 0.47% for the three months ended September 30, 2016, compared to 0.69% for the three months ended September 30, 2015, reflecting the significant amount of relatively low cost relationship-based transactional deposits acquired in the Branch Purchase and the decline in the percentage of higher cost certificates of deposit to total deposits over the last year.

Interest expense increased $480,000, or 18.3%, to $3.1 million for the nine months ended September 30, 2016, from $2.6 million for the same period of the prior year. The average cost of funds decreased 13 basis points to 0.59% for the nine months ended September 30, 2016, compared to 0.72% for the nine months ended September 30, 2015. The average cost of deposits decreased 22 basis points to 0.48% for the nine months ended September 30, 2016, compared to 0.70% for the nine months ended September 30, 2015.

Provision for Loan Losses. The provision for loan losses was unchanged at $600,000 for both the three months ended September 30, 2016 and 2015. During the three months ended September 30, 2016, net recoveries totaled $35,000, compared to net charge-offs of $139,000 during the same period last year.

The provision for loan losses was also unchanged at $1.8 million for both the nine months ended September 30, 2016 and 2015. Substandard loans increased $915,000, or 32.1%, to $3.7 million at September 30, 2016, compared to $2.8 million at September 30, 2015. The increase from one year ago was primarily associated with four commercial lines of credit totaling $1.2 million. During the nine months ended September 30, 2016, net recoveries totaled $1,000, compared to net charge-offs of $502,000 during the same period last year.

Noninterest Income. Noninterest income increased $2.9 million, or 65.6%, to $7.2 million for the three months ended September 30, 2016, from $4.4 million for the three months ended September 30, 2015. The increase during the period was primarily due to an increase of $2.3 million in gain on sale of loans, and a $371,000 increase in service charges and fee income primarily associated with the Branch Purchase and growth in the number of home loans serviced by the Bank. One-to-four-family originations of loans held for sale, including loans brokered to other institutions, increased 40.8% to $232.9 million during the quarter ended September 30, 2016, compared to $165.4 million for the same quarter one year ago. The growth in originations was a result of increased purchase activity associated with the strong home purchase demand in the Pacific Northwest and the continued favorable market interest rates. Purchase production increased by $10.0 million, or 7.6% with $141.7 million in purchased loans that closed during the three months ended September 30, 2016, up from $131.7 million for the three months ended September 30, 2015. Refinances increased by $57.4 million, or 170.8%, to $91.0 million for the three months ended September 30, 2016, from $33.6 million for the same period last year. The percentage of one-to-four-family mortgage loan originations for home purchases was 60.9% of third quarter originations versus 39.1% of third quarter originations for refinance activity. This compares to 79.7%

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of originations to purchase a home versus 20.3% to refinance a home in the third quarter of 2015. In addition we recognized a $146,000 gain on sale of investment securities for the three months ended September 30, 2016, compared to none for the same period last year.
Noninterest income increased $4.4 million, or 32.1%, to $18.1 million for the nine months ended September 30, 2016, from $13.7 million for the nine months ended September 30, 2015. The increase during the period was primarily due to an increase of $3.2 million in gain on sale of loans, and a $1.0 million increase in service charges and fee income primarily associated with the Branch Purchase and growth in the number of home loans serviced by the Bank.

Noninterest Expense. Noninterest expense increased $2.5 million, or 31.7% to $10.3 million for the three months ended September 30, 2016, from $7.8 million for the three months ended September 30, 2015. The increase in noninterest expense was primarily a result of a $2.0 million, or 46.4% increase in salaries and benefits which includes $1.8 million of commissions and incentives for the loan production staff, as well as stock-based compensation associated with the 2013 Equity Incentive Plan with the remainder of the increase in salaries and benefits of $200,000 primarily reflecting additional staff due to the Branch Purchase. Other expense categories also increased due to the Branch Purchase including a $332,000, or 29.7% increase in operations costs, a $157,000, or 41.3% increase in data processing, a $140,000, or 100.0% increase in amortization of the core deposit intangible, and a $100,000, or 20.1% increase in occupancy, partially offset by a decrease of $432,000 in acquisition costs. Increases not associated with the Branch Purchase included a $336,000, or 88.7% increase in loan costs, partially offset by a recovery of $216,000 of servicing rights impairment.

Noninterest expense increased $7.1 million, or 32.9% to $28.8 million for the nine months ended September 30, 2016, from $21.7 million for the nine months ended September 30, 2015, primarily as a result of the Branch Purchase and Company growth including a $4.0 million, or 32.5% increase in salaries and benefits, a $1.0 million, or 31.5% increase in operations, a $660,000, or 58.5% increase in loan costs, a $444,000, or 39.2% increase in data processing, a $387,000, or 27.9% increase in occupancy, and a $222,000, or 17.5% increase in professional fees. We also incurred $382,000 in amortization of the core deposit intangible attributable to the Branch Purchase during the nine months ended September 30, 2016, as compared to none in the same period last year.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, improved to 64.5% for the three months ended September 30, 2016, compared to 68.0% for the three months ended September 30, 2015. For the nine months ended September 30, 2016, the efficiency ratio weakened slightly to 67.4% compared to 63.8% for the nine months ended September 30, 2015. Both periods reflect a greater increase in noninterest income and net interest income as compared to a smaller increase in noninterest expense.

Provision for Income Tax. For the nine months ended September 30, 2016, the Company recorded a provision for income tax expense of $4.2 million on pre-tax income as compared to $3.7 million. The effective tax rate for the nine month period ended September 30, 2016 and 2015 was 34.5% and 34.8%, respectively.

Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit runoff that may occur in the normal course of business. The Company relies on a number of different sources in order to meet its potential liquidity demands. The primary sources are increases in deposit accounts, FHLB advances, purchases of Fed Funds, sale of securities available-for-sale, cash flows from loan payments, sales of one-to-four-family loans held for sale, and maturing securities.

At September 30, 2016, the Bank’s total borrowing capacity was $216.2 million with the FHLB of Des Moines, with unused borrowing capacity of $195.0 million. The FHLB borrowing limit is based on certain categories of loans, primarily real estate loans that qualify as collateral for FHLB advances. At September 30, 2016, the Bank held approximately $277.8 million in loans that qualify as collateral for FHLB advances. In addition to the availability of liquidity from the FHLB of Des Moines, the Bank maintained a short-term borrowing line with the Federal Reserve Bank, with a current limit of $83.9 million, and a combined credit limit of $40.0 million in written Fed Funds lines of credit through correspondent banking relationships at September 30, 2016. The Federal Reserve Bank borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for Federal Reserve Bank line of credit. At September 30, 2016, the Bank held approximately $164.4 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

At September 30, 2016, $21.0 million in FHLB advances and FHLB Fed Funds were outstanding, and no advances were outstanding against the Federal Reserve Bank line of credit, and Fed Funds lines of credit. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of Bank deposits or $141.0 million as of September 30, 2016. Total brokered deposits as of September 30, 2016 were $47.1 million.

Liquidity management is both a daily and long-term function of Company management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and Fed Funds. On a longer-term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and federal agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At September 30, 2016, the approved outstanding loan commitments, including unused lines of credit amounted to $294.5 million. Certificates of deposit scheduled to mature in three months or less at September 30, 2016, totaled $21.6 million. It is management's policy to offer deposit rates that are competitive with other local financial institutions. Based on this management strategy, the Company believes that a majority of maturing relationship deposits will remain with the Bank.

As a separate legal entity from the Bank, FS Bancorp, Inc. must provide for its own liquidity. Sources of capital and liquidity for the FS Bancorp, Inc. include distributions from the Bank and the issuance of debt or equity securities. Dividends and other capital distributions from the Bank are subject to regulatory notice. At September 30, 2016, FS Bancorp, Inc. had $2.0 million in cash to meet liquidity needs.

Commitments and Off-Balance Sheet Arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. For information regarding our commitments and off-balance sheet arrangements, see Note 9 of the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

Capital Resources

The Bank is subject to minimum capital requirements imposed by the FDIC. Based on its capital levels at September 30, 2016, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a well capitalized status under the capital categories of the FDIC. Based on capital levels at September 30, 2016, the Bank was considered to be well capitalized. At September 30, 2016, the Bank exceeded all regulatory capital requirements with Tier 1 leverage-based capital, Tier 1 risk-based capital, total risk-based capital, and common equity Tier 1 capital ratios of 10.3%, 12.2%, 13.5%, and 12.2%, respectively. For additional information regarding the Bank's regulatory capital compliance, see the discussion included in Note 14 to the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

For a bank holding company with less than $1 billion in consolidated assets, such as FS Bancorp, Inc., the capital guidelines apply on a bank only basis and the Federal Reserve requires the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If FS Bancorp, Inc. was subject to regulatory guidelines for bank holding companies with $1 billion or more in assets, at September 30, 2016, FS Bancorp, Inc. would have exceeded all regulatory capital requirements.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Not required for smaller reporting companies.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

An evaluation of the disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Act")) at September 30, 2016 was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures in effect at September 30, 2016 were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is: (i) accumulated and communicated to the Company's 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.

(b) Changes in Internal Controls.

There have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the three months ended September 30, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. 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. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls may be circumvented by the individual acts of some persons, by collusion of two or more people, or by override of the control. The design of any control procedure also is 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; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the normal course of business, the Company occasionally becomes involved in various legal proceedings. In the opinion of management, any liability from such proceedings would not have a material adverse effect on the business or financial condition of the Company.

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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

(a) Not applicable

(b) Not applicable

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(c) The following table summarizes common stock repurchases during the three months ended September 30, 2016:

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
July 1, 2016 - July 31, 2016	1,354	$ 25.21	1,354	132,388
August 1, 2016 - August 31, 2016	—	—	—	132,388
September 1, 2016 - September 30, 2016	—	—	—	—
Total	1,354	$ 25.21	1,354	—

The above repurchase plan was announced on July 28, 2015, authorizing the repurchase of up to 325,000 shares, or 10% of the Company's outstanding shares. All shares were repurchased in the open market. The term of the plan covered a twelve month period and ended on August 31, 2016. No other repurchase plans have been authorized.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

3.1 Articles of Incorporation of FS Bancorp, Inc. (1)

3.2 Bylaws of FS Bancorp, Inc. (2)

4.1 Form of Common Stock Certificate of FS Bancorp, Inc. (1)

10.1 Severance Agreement between 1st Security Bank of Washington and Joseph C. Adams (1)

10.2 Form of Change of Control Agreement between 1st Security Bank of Washington and each of Matthew D. Mullet and Drew B. Ness (1)

10.3 FS Bancorp, Inc. 2013 Equity Incentive Plan (the "2013 Plan") (3)

10.4 Form of Incentive Stock Option Agreement under the 2013 Plan (3)

10.5 Form of Non-Qualified Stock Option Agreement under the 2013 Plan (3)

10.6 Form of Restricted Stock Agreement under the 2013 Plan (3)

10.7 Purchase and Assumption Agreement between Bank of America, National Association and 1st Security

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Bank dated September 1, 2015 (4)

10.8 Subordinated Loan Agreement dated September 30, 2015 by and among Community Funding CLO, Ltd. and the Company (5)

10.9 Form of change of control agreement with Donn C. Costa and Debbie L. Steck (6)

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.

(1) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-177125) filed on October 3, 2011, and incorporated by reference.

(2) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on July 10, 2013 (File No. 001-35589).

(3) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-192990) filed on December 20, 2013, and incorporated by reference.

(4) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on September 2, 2015 (File No. 001-35589).

(5) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on October 19, 2015 (File No. 001-35589).

(6) Filed as an exhibit to the Registrant's Current Report on Form 8-K filed on February 1, 2016 (File No. 001-35589).

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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.

FS BANCORP, INC.

Date: November 9, 2016	By: /s/Joseph C. Adams Joseph C. Adams, Chief Executive Officer (Duly Authorized Officer)
Date: November 9, 2016	By: /s/Matthew D. Mullet Matthew D. Mullet Secretary, Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer)

Exhibit Index

Exhibit No.	Description
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Changes in Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements.