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Sound Financial Bancorp, Inc.
Form 10-Q
August 15, 2013

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

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from to

COMMISSION FILE NUMBER 001-35633

Sound Financial Bancorp, Inc.

(Exact Name of Registrant as Specified in its Charter)

Maryland

(State or other jurisdiction of incorporation or
organization)

45-5188530

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

2005 5th Avenue, Suite 200, Seattle, Washington
(Address of principal executive offices)

98121
(Zip Code)

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

None

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting
Company

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(Do not check if smaller
reporting company)

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [] NO [X]

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

As of August 12, 2013, there were 2,586,810 shares of the registrant's common stock outstanding.

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

	Page Number
PART I FINANCIAL INFORMATION	
Item 1. Financial Statements	
Condensed Consolidated Balance Sheets as of June 30, 2013 (unaudited) and December 31, 2012	3
Condensed Consolidated Statements of Income for the Three and Six Month Periods Ended June 30, 2013 and 2012 (unaudited)	4
Condensed Consolidated Statements of Comprehensive Income for the Three and Six Month Periods Ended June 30, 2013 and 2012 (unaudited)	5
Condensed Consolidated Statement of Stockholders' Equity for the Six Months Ended June 30, 2013 and 2012 (unaudited)	6
Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2013 and 2012 (unaudited)	7
Selected Notes to Condensed Consolidated Financial Statements	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	
Item 3. Quantitative and Qualitative Disclosures About Market Risk	
Item 4. Controls and Procedures	
PART II OTHER INFORMATION	
Item 1. Legal Proceedings	
Item 1A Risk Factors	40
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	40
Item 3. Defaults Upon Senior Securities	40
Item 4. Mine Safety Disclosures	40
Item 5. Other Information	40
Item 6. Exhibits	41

SIGNATURES

EXHIBITS

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Balance Sheets (Unaudited)
(In thousands, except share amounts)

	June 30, 2013	December 31, 2012
ASSETS		
Cash and cash equivalents	\$11,760	\$12,727
Available-for-sale securities, at fair value	16,965	22,900
Loans held for sale	2,078	1,725
Loans	358,659	326,744
Allowance for loan losses	(4,129)	(4,248)
Total Loans, net	354,530	322,496
Accrued interest receivable	1,333	1,280
Bank-owned life insurance (“BOLI”), net	10,872	7,220
Other real estate owned (“OREO”) and repossessed assets, net	1,190	2,503
Mortgage servicing rights, at fair value	2,670	2,306
Federal Home Loan Bank (“FHLB”) stock, at cost	2,357	2,401
Premises and equipment, net	2,233	2,256
Other assets	3,577	3,230
Total assets	\$409,565	\$381,044
LIABILITIES		
Deposits		
Interest-bearing	\$285,544	\$276,849
Noninterest-bearing demand	33,970	35,234
Total deposits	319,514	312,083
Accrued interest payable	72	83
Other liabilities	3,663	3,226
Advance payments from borrowers for taxes and insurance	277	331
Borrowings	40,542	21,864
Total liabilities	364,068	337,587
COMMITMENTS AND CONTINGENCIES (NOTE 8)		
STOCKHOLDERS' EQUITY		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized, none issued or outstanding	-	-
Common stock, \$0.01 par value, 40,000,000 shares authorized, 2,586,810 and 2,587,544 shares issued and outstanding as of June 30, 2013 and December 31, 2012, respectively	26	26
Additional paid-in capital	24,873	24,789
Unearned shares - Employee Stock Ownership Plan (“ESOP”)	(1,598)	(1,598)
Retained earnings	22,546	20,736
Accumulated other comprehensive loss, net of tax	(350)	(496)
Total stockholders' equity	45,497	43,457
Total liabilities and stockholders' equity	\$409,565	\$381,044

See notes to condensed consolidated financial statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
INTEREST INCOME				
Loans, including fees	\$4,838	\$4,514	\$9,342	\$9,022
Interest and dividends on investments, cash and cash equivalents	48	84	180	139
Total interest income	4,886	4,598	9,522	9,161
INTEREST EXPENSE				
Deposits	498	531	999	1,076
Borrowings	46	57	114	112
Total interest expense	544	588	1,113	1,188
Net interest income	4,342	4,010	8,409	7,973
PROVISION FOR LOAN LOSSES				
Net interest income after provision for loan losses	3,892	2,910	7,709	5,373
NONINTEREST INCOME				
Service charges and fee income	551	513	1,150	1,064
Earnings on cash surrender value of bank-owned life insurance	74	52	152	118
Mortgage servicing income	184	21	311	199
Fair value adjustment on mortgage servicing rights	250	(76)	385	308
Other-than-temporary impairment losses on securities	(11)	(32)	(30)	(124)
Net gain on sale of loans	310	308	756	559
Total noninterest income	1,358	786	2,724	2,124
NONINTEREST EXPENSE				
Salaries and benefits	1,705	1,423	3,392	2,705
Operations	991	728	1,958	1,310
Regulatory assessments	82	99	182	221
Occupancy	309	294	608	604
Data processing	318	262	606	505
Net loss on OREO and repossessed assets	164	22	838	492
Total noninterest expense	3,569	2,828	7,584	5,837
Income before provision for income taxes	1,681	868	2,849	1,660
Provision for income taxes	539	275	910	520
Net income	\$1,142	\$593	\$1,939	\$1,139
Earnings per common share:				
Basic	\$0.44	\$0.22	\$0.75	\$0.44
Diluted	\$0.43	\$0.22	\$0.74	\$0.43
Weighted average number of common shares outstanding:				
Basic	2,586,810	2,587,760	2,586,940	2,584,696
Diluted	2,637,726	2,615,484	2,636,358	2,610,184

See notes to condensed consolidated financial statements

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Net income	\$1,142	\$593	\$1,939	\$1,139
Available for sale securities:				
Unrealized gains (losses) arising during the period, net of taxes of \$48, \$(17), \$65 and \$22, respectively	94	(33)	126	42
Reclassification adjustments for other-than-temporary impairment, net of taxes of \$4, \$11, \$10 and \$42, respectively	7	21	20	82
Other comprehensive income (loss), net of tax	101	(12)	146	124
Comprehensive income	\$1,243	\$581	\$2,085	\$1,263

See notes to condensed consolidated financial statements

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
 Condensed Consolidated Statements of Stockholders' Equity
 For the Six Months Ended June 30, 2013 and 2012 (unaudited)
 (In thousands, except number of shares)

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Total Stockholders' Equity
Balances at December 31, 2011	2,949,045	\$30	\$11,939	\$(693)	\$18,096	\$(659)	\$28,713
Net income					1,139		1,139
Other comprehensive income, net of tax						124	124
Restricted stock awards	11,000						-
Share-based compensation			66				66
Balances at June 30, 2012	2,960,045	\$30	\$12,005	\$(693)	\$19,235	\$(535)	\$30,042
	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Total Stockholders' Equity
Balances at December 31, 2012	2,587,544	\$26	\$24,789	\$(1,598)	\$20,736	\$(496)	\$43,457
Net income					1,939		1,939
Other comprehensive income, net of tax						146	146
Share-based compensation			84				84
Restricted stock forfeited and retired	(734)						
Cash dividends on common stock (\$0.05 per share)					(129)		(129)

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Balances at June									
30, 2013	2,586,810	\$ 26	\$ 24,873	\$ (1,598)	\$ 22,546	\$ (350)	\$ 45,497		

See notes to condensed consolidated financial statements

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

	Six Months Ended June 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$1,939	\$1,139
Adjustments to reconcile net income to net cash from operating activities		
Accretion of net premium on investments	279	(9)
Other-than-temporary impairment losses on securities	30	124
Provision for loan losses	700	2,600
Depreciation and amortization	223	180
Compensation expense related to stock options and restricted stock	84	66
Fair value adjustment on mortgage servicing rights	(385)	(308)
Additions to mortgage servicing rights	(495)	(328)
Amortization of mortgage servicing rights	516	515
Increase in cash surrender value of BOLI	(152)	(118)
Gain on sale of loans	(756)	(559)
Proceeds from sale of loans	74,937	33,046
Originations of loans held for sale	(74,534)	(31,733)
Loss on sale of OREO and repossessed assets	776	169
Change in operating assets and liabilities		
Accrued interest receivable	(53)	-
Other assets	(422)	(1,331)
Accrued interest payable	(11)	(6)
Other liabilities	437	629
Net cash from operating activities	3,113	4,076
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from principal payments, maturities and sales of available for sale securities	5,847	263
FHLB stock redeemed	44	-
Purchase of available for sale securities	-	(6,231)
Net increase in loans	(33,999)	(10,583)
Improvements to OREO and other repossessed assets	(33)	(358)
Proceeds from sale of OREO and other repossessed assets	1,835	1,850
Purchases of premises and equipment, net	(200)	(28)
Purchases of BOLI	(3,500)	-
Net cash used by investing activities	(30,006)	(15,087)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	7,431	13,732
Proceeds from borrowings	160,000	-
Repayment of borrowings	(141,322)	(321)
Dividends paid on common stock	(129)	-
Net change in advances from borrowers for taxes and insurance	(54)	(31)
Net cash from financing activities	25,926	13,380
Net increase in cash and cash equivalents	(967)	2,369
Cash and cash equivalents, beginning of period	12,727	17,031
Cash and cash equivalents, end of period	\$11,760	\$19,400
SUPPLEMENTAL CASH FLOW INFORMATION:		

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Cash paid for income taxes	\$730	\$75
Interest paid on deposits and borrowings	\$1,124	\$1,194
Noncash net transfer from loans to OREO and repossessed assets	\$1,265	\$1,679

See notes to condensed consolidated financial statements

7

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

Note 1 – Basis of Presentation

The accompanying financial information is unaudited and has been prepared from the consolidated financial statements of Sound Financial Bancorp, Inc. (“we,” “us,” “our,” “Sound Financial Bancorp,” or the “Company”) and its wholly owned subsidiary, Sound Community Bank (the “Bank”). These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. These unaudited financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2012, as filed with the SEC on March 31, 2013 (“2012 Form 10-K”). The results for the interim periods are not necessarily indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2012, included in the 2012 Form 10-K.

Certain amounts in the prior quarters’ consolidated financial statements have been reclassified to conform to the current presentation. These classifications do not have an impact on previously reported net income, retained earnings or earnings per share.

On August 22, 2012, the Company completed its conversion from the mutual holding company structure and related public stock offering, so that it is now a stock holding company that is wholly owned by public shareholders. Please see Note 2 – Conversion and Stock Issuance for more information.

Note 2 – Conversion and Stock Issuance

The Company, a Maryland corporation, was organized by Sound Community MHC, Sound Financial, Inc. and Sound Community Bank to facilitate the “second-step” conversion of Sound Community Bank from the mutual holding company structure to the stock holding company structure (the “Conversion”). Upon consummation of the Conversion, which occurred on August 22, 2012, the Company became the holding company for Sound Community Bank and now owns all of the issued and outstanding shares of Sound Community Bank’s common stock.

In connection with the Conversion, the Company sold a total of 1,417,500 shares of common stock in offering to certain depositors of Sound Community Bank and others, including 113,400 shares to the Sound Community Bank employee stock ownership plan (“ESOP”). All shares were sold at a purchase price of \$10.00 per share. Proceeds from the offering, net of \$1.5 million in expenses, totaled \$12.7 million. The Company used \$1.1 million of the proceeds to fund the ESOP and made a \$7.5 million capital contribution to the Bank. In addition, concurrent with the offering, shares of Sound Financial, Inc. common stock owned by public stockholders were exchanged for 0.87423 shares of the Company’s common stock, with cash being paid in lieu of issuing any fractional shares. As a result of the offering, exchange and cash in lieu of fractional shares, the Company had 2,587,544 shares outstanding as of June 30, 2013.

All share and per share information in this report for periods prior to the Conversion has been revised to reflect the 0.87423 Conversion exchange ratio.

Note 3 – Accounting Pronouncements Recently Issued or Adopted

In January 2013, the FASB issued ASU No. 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. This update clarifies that ASU No. 2011-11 applies only to derivatives, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset or subject to an enforceable master netting arrangement or similar agreement. Entities with other types of financial assets and financial liabilities subject to a master netting arrangement or similar agreement are no longer subject to the disclosure requirements in ASU No. 2011-11. The amendments were effective for annual and interim reporting periods beginning on or after January 1, 2013. The adoption of ASU No. 2013-01 did not have a material impact on the Company's consolidated financial statements.

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

In February 2013, the FASB issued ASU No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments were effective for annual and interim reporting periods beginning on or after December 15, 2012. The adoption of this update did not have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-10, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes. This update permits the use of the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge account purposes. The amendment is effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this update is not expected to have a material impact on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. This update requires an entity to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. No new recurring disclosures are required. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2013 and are to be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of this update is not expected to have a material impact on the Company's consolidated financial statements.

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

Note 4 – Investments

The amortized cost and fair value of our available-for-sale securities (“AFS”) and the corresponding amounts of gross unrealized gains and losses at the dates indicated were as follows: The amortized cost and fair value of mortgage-backed securities by contractual maturity, at June 30, 2013, are shown below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Gains	Gross Unrealized Losses 1 Year Or Less	Losses Greater Than 1 Year	Estimated Fair Value
June 30, 2013	(in thousands)				
Agency mortgage-backed securities	\$14,580	\$11	\$(300)	\$-	\$14,290
Non-agency mortgage-backed securities	2,916	132	-	\$(373)	2,675
Total	\$17,496	\$143	\$(300)	\$(373)	\$16,965
December 31, 2012					
Agency mortgage-backed securities	\$20,378	\$27	\$(278)	\$-	\$20,127
Non-agency mortgage-backed securities	3,273	19	-	(519)	2,773
Total	\$23,651	\$46	\$(278)	\$(519)	\$22,900

	At June 30, 2013	
	Amortized Cost	Fair Value
	(In thousands)	
Due after ten years	\$17,496	\$16,965

Securities with an amortized cost of \$7.2 million and fair value of \$7.1 million at June 30, 2013 were pledged to secure Washington State Public Funds. Additionally, the Company has letters of credit with a notional amount of \$20.0 million to secure public deposits.

There were no sales of available for sale securities during the three and six months ended June 30, 2013 and 2012.

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

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

	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	June 30, 2013 (in thousands)					
Agency mortgage-backed securities	\$13,792	\$(300)	\$-	\$-	\$13,792	\$(300)
Non-agency mortgage-backed securities	-	-	680	(373)	680	(373)
Total	\$13,792	\$(300)	\$680	\$(373)	\$14,472	\$(673)

	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	December 31, 2012 (in thousands)					
Agency mortgage-backed securities	\$17,685	\$(278)	\$-	\$-	\$17,685	\$(278)
Non-agency mortgage-backed securities	-	-	2,137	(519)	2,137	(519)
Total	\$17,685	\$(278)	\$2,137	\$(519)	\$19,822	\$(797)

The following table presents the cumulative roll forward of credit losses recognized in earnings during the six months ended June 30, 2013 and 2012 relating to the Company's non-U.S. agency mortgage backed securities:

	Three months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
	(in thousands)			
Estimated credit losses, beginning balance	\$439	\$347	\$420	\$255
Additions for credit losses not previously recognized	11	32	30	124
Reduction for increases in cash flows	-	-	-	-
Reduction for realized losses	-	-	-	-
Estimated credit losses, ending balance	\$450	\$379	\$450	\$379

All of the agency mortgage-backed securities in an unrealized loss position at June 30, 2013 are issued or guaranteed by governmental agencies. The unrealized losses were caused by changes in market interest rates or the widening of market spreads subsequent to the initial purchase of these securities, and not related to the underlying credit of the issuers or the underlying collateral. It is expected that these securities will not be settled at a price less than the amortized cost of each investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because the Bank does not intend to sell the securities in this class

and it is not likely that the Bank will be required to sell these securities before recovery of their amortized cost basis, which may include holding each security until contractual maturity, the unrealized losses on these investments are not considered other-than-temporarily impaired.

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

As of June 30, 2013, our securities portfolio consisted of 17 U.S. agency and five non-U.S. agency mortgage backed securities with a fair value of \$17.0 million. Two of the five non-U.S. agency securities and 14 of the 17 U.S. agency securities were in an unrealized loss position. The unrealized losses were caused by changes in interest rates and market illiquidity causing a decline in the fair value subsequent to the purchase. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. While management does not intend to sell the non-agency mortgage backed securities, and it is unlikely that the Company will be required to sell these securities before recovery of its amortized cost basis, management's impairment evaluation indicates that certain securities possess qualitative and quantitative factors that suggest an other-than-temporary impairment ("OTTI"). These factors include, but are not limited to: the length of time and extent of the fair value declines, ratings agency down grades, the potential for an increased level of actual defaults, and the extension in duration of the securities. In addition to the qualitative factors, management's evaluation includes an assessment of quantitative evidence that involves the use of cash flow modeling and present value calculations as determined by considering the applicable OTTI accounting guidance. The Company compares the present value of the current estimated cash flows to the present value of the previously estimated cash flows. Accordingly, if the present value of the current estimated cash flows is less than the present value of the previous period's present value, an adverse change is considered to exist and the security is considered OTTI. The associated "credit loss" is the amount by which the security's amortized cost exceeds the present value of the current estimated cash flows. Based upon the results of the cash flow modeling, one security reflected OTTI of \$30,000 during the six months ended June 30, 2013. Estimating the expected cash flows and determining the present values of the cash flows involves the use of a variety of assumptions and complex modeling. In developing its assumptions, the Company considers all available information relevant to the collectability of the applicable security, including information about past events, current conditions, and reasonable and supportable forecasts. Furthermore, the Company asserts that the cash flows used in the determination of OTTI are its "best estimate" of cash flows.

Note 5 – Loans

The composition of the loan portfolio at the dates indicated, including loans held for sale, was as follows:

	At June 30, 2013	At December 31, 2012
	(in thousands)	
Real estate loans:		
One- to four- family	\$103,484	\$95,784
Home equity	35,055	35,364
Commercial and multifamily	149,157	133,620
Construction and land	38,409	25,458
Total real estate loans	326,105	290,226
Consumer loans:		
Manufactured homes	14,682	16,232
Other consumer	9,265	8,650
Total consumer loans	23,947	24,882
Commercial business loans	11,802	14,193

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Total loans	361,854	329,301
Deferred fees	(1,117)	(832)
Loans held for sale	(2,078)	(1,725)
Total loans, gross	358,659	326,744
Allowance for loan losses	(4,129)	(4,248)
Total loans, net	\$354,530	\$322,496

12

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

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of June 30, 2013:

	One-to- four family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Unallocated	Total
(In thousands)									
Allowance for loan losses:									
Individually evaluated for impairment	\$315	\$160	\$ -	\$ 18	\$ 122	\$8	\$ 1	\$ -	\$624
Collectively evaluated for impairment	1,233	730	583	429	145	146	96	143	3,505
Ending balance	\$1,548	\$890	\$ 583	\$ 447	\$ 267	\$154	\$ 97	\$ 143	\$4,129
Loans receivable:									
Individually evaluated for impairment	\$4,945	\$1,802	\$ 2,814	\$ 741	\$ 638	\$55	\$ 162	\$ -	\$11,157
Collectively evaluated for impairment	98,539	33,253	146,343	37,668	14,044	9,210	11,640	-	350,697
Ending balance	\$103,484	\$35,055	\$ 149,157	\$ 38,409	\$ 14,682	\$9,265	\$ 11,802	\$ -	\$361,854

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2012:

	One-to- four family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Unallocated	Total
(In thousands)									
Allowance for loan losses:									
Individually evaluated for impairment	\$392	\$247	\$ 70	\$ 25	\$ 117	\$22	\$ 145	\$ -	\$1,018
Collectively evaluated	1,025	750	422	192	143	124	73	501	3,230

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for impairment									
Ending balance	\$1,417	\$997	\$ 492	\$ 217	\$ 260	\$146	\$ 218	\$ 501	\$4,248
Loans receivable:									
Individually evaluated for impairment	\$6,016	\$1,731	\$ 2,127	\$ 571	\$ 654	\$55	\$ 839	\$ -	\$11,993
Collectively evaluated for impairment	89,768	33,633	131,493	24,887	15,578	8,595	13,354	-	317,308
Ending balance	\$95,784	\$35,364	\$ 133,620	\$ 25,458	\$ 16,232	\$8,650	\$ 14,193	\$ -	\$329,301

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

The following table summarizes the activity in loan losses for the three months ended June 30, 2013:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to-four family	\$1,299	\$(257)	\$-	\$506	\$1,548
Home equity	1,003	(74)	4	(43)	890
Commercial and multifamily	527	-	2	54	583
Construction and land	287	-	-	160	447
Manufactured homes	217	(30)	-	80	267
Other consumer	178	(16)	6	(14)	154
Commercial business	200	(2)	-	(101)	97
Unallocated	335	-	-	(192)	143
Total	\$4,046	\$(379)	\$12	\$450	\$4,129

The following table summarizes the activity in loan losses for the six months ended June 30, 2013:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to-four family	\$1,417	\$(326)	\$-	\$457	\$1,548
Home equity	997	(221)	6	108	890
Commercial and multifamily	492	(192)	34	249	583
Construction and land	217	(7)	-	237	447
Manufactured homes	260	(54)	-	61	267
Other consumer	146	(27)	14	21	154
Commercial business	218	(46)	-	(75)	97
Unallocated	501	-	-	(358)	143
Total	\$4,248	\$(873)	\$54	\$700	\$4,129

The following table summarizes the activity in loan losses for the three months ended June 30, 2012:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to-four family	\$1,582	\$(650)	\$4	\$740	\$1,676
Home equity	1,410	(20)	130	(308)	1,212
Commercial and multifamily	508	(503)	83	559	647
Construction and land	66	(4)	-	119	181
Manufactured homes	377	(32)	-	(9)	336
Other consumer	142	(27)	9	49	173
Commercial business	234	(1)	10	(28)	215
Unallocated	31	-	-	(22)	9
Total	\$4,350	\$(1,237)	\$236	\$1,100	\$4,449

The following table summarizes the activity in loan losses for the six months ended June 30, 2012:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to-four family	\$1,117	\$(1,399)	) \$4	\$1,954	\$1,676
Home equity	1,426	(735)	) 132	389	1,212
Commercial and multifamily	969	(503)	) 83	98	647
Construction and land	105	(41)	) -	117	181
Manufactured homes	290	(60)	) -	106	336
Other consumer	213	(106)	) 16	50	173
Commercial business	254	(7)	) 10	(42)	) 215
Unallocated	81	-	-	(72)	) 9
Total	\$4,455	\$(2,851)	) \$245	\$2,600	\$4,449

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

Credit Quality Indicators. Federal regulations provide for the classification of lower quality loans as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without establishment of a specific loss reserve is not warranted.

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

The following table represents the internally assigned grades as of June 30, 2013 by type of loan:

Grade:	One-to-four family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
	(in thousands)							
Pass	\$91,028	\$30,411	\$ 144,942	\$ 37,885	\$ 13,027	\$ 8,786	\$ 10,363	\$336,442
Watch	10,268	3,528	978	421	1,604	446	889	18,134
Special Mention	48	138	652	-	-	-	550	1,388
Substandard	2,140	978	2,585	103	51	33	-	5,890
Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	\$103,484	\$35,055	\$ 149,157	\$ 38,409	\$ 14,682	\$ 9,265	\$ 11,802	\$361,854

The following table represents the internally assigned grades as of December 31, 2012 by type of loan:

Grade:	One-to-four family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
	(in thousands)							
Pass	\$84,685	\$30,927	\$ 130,721	\$ 24,641	\$ 14,898	\$ 8,102	\$ 12,290	\$306,264
Watch	8,279	3,064	954	347	1,312	520	1,087	15,563
Special Mention	490	499	595	-	-	-	-	1,584
Substandard	2,329	874	1,350	471	23	28	815	5,890

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Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	\$95,784	\$35,364	\$ 133,620	\$ 25,458	\$ 16,232	\$8,650	\$ 14,193	\$329,301

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 three months past due or sooner if, in management's opinion, the borrower may be unable to meet payment of obligations as they become due, as well as when required by regulatory provisions.

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

The following table presents the recorded investment in nonaccrual loans as of June 30, 2013 and December 31, 2012, by type of loan:

	June 30, 2013	December 31, 2012
	(in thousands)	
One- to four- family	\$784	\$1,013
Home equity	443	332
Commercial and multifamily	230	1,106
Construction and land	-	471
Other consumer	24	1
Commercial business	-	80
Total	\$1,481	\$3,003

The following table represents the aging of the recorded investment in past due loans as of June 30, 2013 by type of loan:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Recorded Investment > 90 Days and Accruing (in thousands)	Total Past Due	Current	Total Loans
One-to-four family	\$-	\$479	\$684	\$-	\$1,163	\$102,321	\$103,484
Home equity	361	28	443	-	832	34,223	35,055
Commercial and multifamily	-	-	230	-	230	148,927	149,157
Construction and land	-	-	-	-	-	38,409	38,409
Manufactured homes	110	-	24	-	134	14,548	14,682
Other consumer	3	9	-	-	12	9,253	9,265
Commercial business	-	-	-	-	-	11,802	11,802
Total	\$474	\$516					