FS Bancorp, Inc.
Form 10-K
March 16, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark one)

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

For the fiscal year ended December 31, 2016 OR

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

Commission File Number: 001-35589

FS BANCORP, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Washington<br>(State or other jurisdiction of incorporation or organization) | 45-4585178<br>(I.R.S. Employer Identification Number) |
| 6920 220th Street SW, Mountlake Terrace, Washington<br>(Address of principal executive offices) | 98043<br>(Zip Code) |
| Registrant's telephone number, including area code: | (425) 771-5299 |
| Securities registered pursuant to Section 12(b) of the Act: | None |
| Securities registered pursuant to Section 12(g) of the Act: | Common Stock, par value $0.01 per share<br>(Title of Each Class) |

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES [ ] NO [X]

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES [ ] NO [X]

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 disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or other information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [X]

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 definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

As of March 10, 2017, there were 3,065,266 shares of the Registrant's common stock outstanding. The Registrant's common stock is listed on the NASDAQ Capital Market under the symbol "FSBW." The aggregate market value of the common stock held by non-affiliates of the Registrant was $70,082,357, based on the closing sales price of $25.35 per share of the Registrant's common stock as quoted on the NASDAQ Capital Market on June 30, 2016. For purposes of this calculation, common stock held only by executive officers and directors of the Registrant is considered to be held by affiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the definitive Proxy Statement for the 2017 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

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

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## Forward-Looking Statements

This Form 10-K contains 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 and 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, the branches we purchased from Bank of America;
- 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, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act, changes in regulation policies and principles, an increase in regulatory capital requirements or change in 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;
- 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-K and our other reports filed with the U.S. Securities and Exchange Commission.

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Any of the forward-looking statements made in this Form 10-K 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.

Available Information

The Company provides a link on its investor information page at www.fsbwa.com to filings with the U.S. Securities and Exchange Commission (“SEC”) for purposes of providing copies of its annual report to shareholders, annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and press releases. Other than an investor’s own internet access charges, these filings are available free of charge and also can be obtained by calling the SEC at 1-800-SEC-0330. The information contained on the Company’s website is not included as part of, or incorporated by reference into, this Annual Report on Form 10-K.

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PART 1
Item 1. Business

General
FS Bancorp, Inc. ( “FS Bancorp” or the “Company”), a Washington corporation, was organized in September 2011 for the purpose of becoming the holding company of 1st Security Bank of Washington (“1st Security Bank of Washington” or the “Bank”) upon the Bank’s conversion from a mutual to a stock savings bank (“Conversion”). The Conversion was completed on July 9, 2012. At December 31, 2016, the Company had consolidated total assets of $827.9 million, total deposits of $712.6 million, and stockholders’ equity of $81.0 million. The Company has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this Annual Report on Form 10-K (“Form 10-K”), including the consolidated financial statements and related data, relates primarily to the Bank.
1st Security Bank of Washington is a relationship-driven community bank. The Bank delivers banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Bank emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Bank is also actively involved in community activities and events within these market areas, which further strengthens relationships within these markets. The Bank has been serving the Puget Sound area since 1936. Originally chartered as a credit union, and known as Washington’s Credit Union, the Bank served various select employment groups. On April 1, 2004, the Bank converted from a credit union to a Washington state-chartered mutual savings bank. Upon completion of the Conversion in July 2012, 1st Security Bank of Washington became a Washington state-chartered stock savings bank and the wholly owned subsidiary of the Company.
At December 31, 2016, the Bank maintained its main administrative office, eleven bank branch locations and seven loan production offices in suburban communities in the greater Puget Sound area. The Bank also has one loan production office in the Tri-Cities, Washington opened in the fourth quarter of 2014. The Bank purchased four retail bank branches from Bank of America (two in Clallam and two in Jefferson counties) on January 22, 2016 (the “Branch Purchase”). These branches opened as 1st Security Bank branches on January 25, 2016. See Item 8, “Financial Statements and Supplementary Data - Notes to Consolidated Financial Statements - Note 2 Business Combinations” of this Form 10-K. In November 2016, the Bank installed a free standing ATM in Kingston, Washington.
The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, home loans, commercial real estate mortgage loans, commercial business loans and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans, represent the largest portion of the loan portfolio and have traditionally been the mainstay of the Company’s lending strategy. Going forward, the Company plans to place more emphasis on certain lending products, such as commercial real estate loans including speculative residential construction loans, one-to-four-family loans, and commercial business loans, while growing the current size of the consumer loan portfolio. The Company reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale into the secondary market, through a mortgage banking program. The Company's lending strategies are intended to take advantage of: (1) the Company’s historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities, and (3) relationship lending. Retail deposits will continue to serve as an important funding source. For more information regarding the business and operations of 1st Security Bank of Washington, see Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Form 10-K.
1st Security Bank of Washington is examined and regulated by the Washington State Department of Financial Institutions (“DFI”), its primary regulator, and by the Federal Deposit Insurance Corporation (“FDIC”). 1st Security Bank of Washington is required to have certain reserves set by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and is a member of the Federal Home Loan Bank of Des Moines (“FHLB” or “FHLB of Des Moines”), which is one of the 11 regional banks in the Federal Home Loan Bank System.

The principal executive offices of the Company are located at 6920 220th Street SW, Mountlake Terrace, Washington 98043 and its telephone number is (425) 771-5299.

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Market Area

The Company conducts operations out of its main administrative office, seven loan production offices, and eleven full-service bank branch offices in the Puget Sound region of Washington, as well as one loan production office in eastern Washington. The administrative office is located in Mountlake Terrace, in Snohomish County, Washington. The four stand-alone home lending offices in the Puget Sound region are located in Puyallup, in Pierce County, Bellevue, in King County, Port Orchard, in Kitsap County, Everett, in Snohomish County, and the one stand-alone home lending office is located in Tri-Cities (Kennewick), in Benton County, Washington. Regarding the eleven full-service bank branches, three branch offices are located in Snohomish County, two branch offices are located in King County, two branch offices are located in Clallam County, two branch offices in Jefferson County, one branch office is located in Pierce County, and one in Kitsap County. On January 22, 2016, the Bank completed the Branch Purchase and acquired four branches 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 primary market area for business operations is the Seattle-Tacoma-Bellevue, Washington Metropolitan Statistical Area (the “Seattle MSA”). Kitsap County, though not in the Seattle MSA, is also part of the Company’s market area. This overall region is typically known as the Puget Sound region. The population of the Puget Sound region was an estimated 4.2 million in 2016, over half of the state’s population, representing a large population base for potential business. The region has a well-developed urban area in the western portion along Puget Sound, with the north, central and eastern portions containing a mixture of developed residential and commercial neighborhoods and undeveloped, rural neighborhoods.
The Puget Sound region is the largest business center in both the State of Washington and the Pacific Northwest. Currently, key elements of the economy are aerospace, military bases, clean technology, biotechnology, education, information technology, logistics, international trade and tourism. The region is well known for the long presence of The Boeing Corporation and Microsoft, two major industry leaders, and for its leadership in technology. Amazon.com has expanded significantly in the Seattle downtown area. The workforce in general is well-educated and strong in technology. Washington State’s location with regard to the Pacific Rim, along with a deepwater port has made international trade a significant part of the regional economy. Tourism has also developed into a major industry for the area, due to the scenic beauty, temperate climate and easy accessibility.
King County, the location of the city of Seattle, has the largest employment base and overall level of economic activity. Six of the largest employers in the state are headquartered in King County including Microsoft Corporation, University of Washington, Amazon.com, Starbucks, Costco, and Swedish Health Services. Pierce County’s economy is also well diversified with the presence of military related government employment (Joint Base Lewis-McChord), along with health care (the Multicare Health System and the Franciscan Health System). In addition, there is a large employment base in the economic sectors of shipping (the Port of Tacoma) and aerospace employment (Boeing). Snohomish County to the north has an economy based on aerospace employment (Boeing), military (the Everett Naval Station) along with additional employment concentrations in biotechnology, electronics/computers, and wood products.
The United States Navy is a key element for Kitsap County’s economy. The United States Navy is the largest employer in the county, with installations at Puget Sound Naval Shipyard, Naval Undersea Warfare Center Keyport and Naval Base Kitsap (which comprises former Naval Submarine Base Bangor, and Naval Station Bremerton). The largest private employers in the county are the Harrison Medical Center and Port Madison Enterprises.
In 2010, approximately 86.6% of King County households had income levels in excess of $50,000 annually, compared to 82.5% for the State of Washington and 79.2% for the United States. In 2008, the U.S. Census Bureau determined that Seattle had the highest percentage of college and university graduates of any U.S. city. Seattle has been listed in the top three most literate cities in the country every year since 2005 by an annual review conducted by Central Connecticut State University. Seattle’s high income and education levels, especially compared to other major

cities, result in King County ranking in the top 100 wealthiest counties in the United States based on 2011 non-census U.S. Census Bureau gathered data.

Unemployment in Washington was an estimated 5.2% as of December 31, 2016, down from a high of 10.2% in March 2010, closely paralleling national trends as disclosed in the U.S. Bureau of Labor Statistics. King County had the lowest unemployment rate in the state at 3.4%, much lower than the state average of 5.2% and national average of

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4.9%, respectively, and improved from 4.5% at year end 2015. At December 31, 2016, the estimated unemployment rate in Pierce County was 6.0%, down from 6.1% as of December 31, 2015. The estimated unemployment rate in Snohomish County at year end 2016 was 3.9%, down from 5.0% at year end 2015. Kitsap County's unemployment rate remained the same with an estimated 5.5% at both December 31, 2016 and 2015. Of the four counties, King and Snohomish counties reflected the largest improvement year over year with unemployment dropping 1.1% in both counties. Outside of the Puget Sound area, the Tri-Cities market includes two counties, Benton and Franklin, and the recently acquired four retail branches are in Clallam and Jefferson counties. The estimated unemployment rate in Benton County at year end 2016 was 7.0%, down slightly from 7.1% at year end 2015. At December 31, 2016, the estimated unemployment rate in Franklin County rose slightly to 9.5%, from 9.4% at December 31, 2015. For Clallam and Jefferson counties, the estimated unemployment rates at December 31, 2016 was 8.1% and 7.4%, respectively, compared to 8.3% and 7.3%, respectively at December 31, 2015.

According to the Washington Center for Real Estate Research, home values in the State of Washington continued to improve in 2016. For the quarter ended December 31, 2016, the average home value was $590,000 in King County, $393,000 in Snohomish County, $288,000 in Kitsap County, $286,000 in Pierce County, $221,000 for both Benton and Franklin counties, $243,000 for Clallam County, and $353,000 for Jefferson County. Compared to the statewide average increase in home values of 10.3% in the fourth quarter of 2016, Jefferson, King, Clallum, and Pierce counties outperformed the state average, with 22.2%, 19.3%, 12.8%, and 12.2% increases, respectively. Although below the state average, Snohomish County experienced a 9.1% increase in home values during 2016, Kitsap County was up 7.4%, and both Benton and Franklin counties increased 6.1% year over year.

For a discussion regarding the competition in the Company's primary market area, see "Competition."

Lending Activities

General.  Historically, the Company's primary emphasis was the origination of consumer loans (primarily indirect home improvement and automobile-secured loans), one-to-four-family residential first mortgages, and second mortgage/home equity loan products. As a result of the Company's initial public offering in 2012, while maintaining the active indirect consumer lending program, the Company shifted its lending focus to include non-mortgage commercial business loans, as well as commercial real estate which includes construction and development loans. The Company reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale in the secondary market. While maintaining the Company's historical strength in consumer lending, the Company has added management and personnel in the commercial and home lending areas to take advantage of the relatively favorable long-term business and economic environments prevailing in the markets.

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Loan Portfolio Analysis. The following table sets forth the composition of the loan portfolio by type of loan at the dates indicated.

| | December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2016 | | 2015 | | 2014 | | 2013 | | 2012 | |
| Real estate loans | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Perce |
| Commercial | $55,871 | 9.23 % | $50,034 | 9.78 % | $42,970 | 10.90 % | $32,970 | 11.48 % | $33,250 | 11.88 |
| Construction and development | 94,462 | 15.60 | 80,806 | 15.80 | 57,813 | 14.67 | 41,633 | 14.49 | 31,893 | 11.39 |
| Home equity | 20,081 | 3.32 | 16,540 | 3.24 | 15,737 | 3.99 | 15,172 | 5.28 | 15,474 | 5.53 |
| One-to-four-family(1) | 124,009 | 20.48 | 102,921 | 20.13 | 46,801 | 11.87 | 20,809 | 7.25 | 13,976 | 4.99 |
| Multi-family | 37,527 | 6.20 | 22,223 | 4.35 | 16,201 | 4.11 | 4,682 | 1.63 | 3,202 | 1.14 |
| Total real estate loans | 331,950 | 54.83 | 272,524 | 53.30 | 179,522 | 45.54 | 115,266 | 40.13 | 97,795 | 34.93 |
| | | | | | | | | | | |
| Consumer loans | | | | | | | | | | |
| Indirect home improvement | 107,759 | 17.80 | 103,064 | 20.16 | 99,304 | 25.19 | 91,167 | 31.74 | 83,786 | 29.93 |
| Solar | 36,503 | 6.03 | 29,226 | 5.72 | 18,162 | 4.61 | 16,838 | 5.86 | 2,463 | 0.89 |
| Marine | 28,549 | 4.71 | 23,851 | 4.66 | 16,713 | 4.24 | 11,203 | 3.90 | 17,226 | 6.15 |
| Other consumer | 1,915 | 0.32 | 2,181 | 0.43 | 2,628 | 0.66 | 3,498 | 1.22 | 5,195 | 1.86 |
| Total consumer loans | 174,726 | 28.86 | 158,322 | 30.97 | 136,807 | 34.70 | 122,706 | 42.72 | 108,670 | 38.83 |
| | | | | | | | | | | |
| Commercial business loans | | | | | | | | | | |
| Commercial and industrial | 65,841 | 10.88 | 59,619 | 11.66 | 55,624 | 14.11 | 42,657 | 14.85 | 34,519 | 12.33 |
| Warehouse lending | 32,898 | 5.43 | 20,817 | 4.07 | 22,257 | 5.65 | 6,587 | 2.30 | 38,946 | 13.91 |
| Total commercial business loans | 98,739 | 16.31 | 80,436 | 15.73 | 77,881 | 19.76 | 49,244 | 17.15 | 73,465 | 26.24 |
| Total loans receivable, gross | 605,415 | 100.00% | 511,282 | 100.00% | 394,210 | 100.00% | 287,216 | 100.00% | 279,930 | 100.0 |
| | | | | | | | | | | |
| Less: | | | | | | | | | | |
| Allowance for loan losses | (10,211 ) | | (7,785 ) | | (6,090 ) | | (5,092 ) | | (4,698 ) | |
| Deferred costs, fees and discounts, net | (1,887 ) | | (962 ) | | (946 ) | | (1,043 ) | | (283 ) | |
| Total loans receivable, net | $593,317 | | $502,535 | | $387,174 | | $281,081 | | $274,949 | |

(1) Excludes loans held for sale.

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The following table shows the composition of the loan portfolio by fixed- and adjustable-rate loans at the dates indicated.

| (Dollars in thousands) | December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Fixed-rate loans: | 2016 | | 2015 | | 2014 | | 2013 | | 2012 | |
| Real estate loans | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Perce |
| Commercial | $30,445 | 5.03 % | $26,189 | 5.12 % | $23,144 | 5.87 % | $23,210 | 8.08 % | $20,947 | 7.48 |
| Construction and development | — | — | 315 | 0.06 | 322 | 0.08 | 525 | 0.18 | 3,958 | 1.41 |
| Home equity | 1,644 | 0.27 | 2,146 | 0.42 | 2,677 | 0.68 | 2,664 | 0.93 | 2,557 | 0.91 |
| One-to-four-family(1) | 10,267 | 1.69 | 9,305 | 1.82 | 8,108 | 2.06 | 19,981 | 6.96 | 8,328 | 2.98 |
| Multi-family | 4,538 | 0.75 | 2,659 | 0.52 | 3,240 | 0.82 | 3,467 | 1.21 | 2,053 | 0.73 |
| Total real estate loans | 46,894 | 7.74 | 40,614 | 7.94 | 37,491 | 9.51 | 49,847 | 17.36 | 37,843 | 13.51 |
| Consumer loans | 174,041 | 28.75 | 157,805 | 30.87 | 136,368 | 34.59 | 122,346 | 42.60 | 108,500 | 38.76 |
| Commercial business loans | | | | | | | | | | |
| Commercial and industrial | 26,901 | 4.45 | 17,440 | 3.41 | 16,197 | 4.11 | 19,792 | 6.89 | 16,959 | 6.06 |
| Total commercial business loans | 26,901 | 4.45 | 17,440 | 3.41 | 16,197 | 4.11 | 19,792 | 6.89 | 16,959 | 6.06 |
| Total fixed-rate loans | 247,836 | 40.94 | 215,859 | 42.22 | 190,056 | 48.21 | 191,985 | 66.85 | 163,302 | 58.33 |
| | | | | | | | | | | |
| Adjustable-rate loans: | | | | | | | | | | |
| Real estate loans | | | | | | | | | | |
| Commercial | 25,426 | 4.20 | 23,845 | 4.66 | 19,826 | 5.03 | 9,760 | 3.40 | 12,303 | 4.40 |
| Construction and development | 94,462 | 15.60 | 80,491 | 15.74 | 57,491 | 14.58 | 41,108 | 14.31 | 27,935 | 9.98 |
| Home equity | 18,437 | 3.05 | 14,394 | 2.82 | 13,060 | 3.31 | 12,508 | 4.35 | 12,917 | 4.62 |
| One-to-four-family(1) | 113,742 | 18.79 | 93,616 | 18.31 | 38,693 | 9.82 | 828 | 0.29 | 5,648 | 2.02 |
| Multi-family | 32,989 | 5.45 | 19,564 | 3.83 | 12,961 | 3.29 | 1,215 | 0.42 | 1,149 | 0.41 |
| Total real estate loans | 285,056 | 47.09 | 231,910 | 45.36 | 142,031 | 36.03 | 65,419 | 22.77 | 59,952 | 21.43 |
| Consumer loans | 685 | 0.11 | 517 | 0.10 | 439 | 0.11 | 360 | 0.12 | 170 | 0.06 |
| Commercial business loans | | | | | | | | | | |
| Commercial and industrial | 38,940 | 6.43 | 42,178 | 8.25 | 39,427 | 10.00 | 22,865 | 7.96 | 17,560 | 6.27 |
| Warehouse lending | 32,898 | 5.43 | 20,818 | 4.07 | 22,257 | 5.65 | 6,587 | 2.30 | 38,946 | 13.91 |
| Total commercial business loans | 71,838 | 11.86 | 62,996 | 12.32 | 61,684 | 15.65 | 29,452 | 10.26 | 56,506 | 20.18 |
| Total adjustable-rate loans | 357,579 | 59.06 | 295,423 | 57.78 | 204,154 | 51.79 | 95,231 | 33.15 | 116,628 | 41.67 |
| Total loans receivable, gross | 605,415 | 100.00 % | 511,282 | 100.00 % | 394,210 | 100.00 % | 287,216 | 100.00 % | 279,930 | 100.0 |
| | | | | | | | | | | |
| Less: | | | | | | | | | | |
| | (10,211 ) | | (7,785 ) | | (6,090 ) | | (5,092 ) | | (4,698 ) | |

| | | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses | | | | | |
| Deferred costs, fees and discounts, net | (1,887) | (962) | (946) | (1,043) | (283) |
| Total loans receivable, net | $593,317 | $502,535 | $387,174 | $281,081 | $274,949 |

(1) Excludes loans held for sale.

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Loan Maturity and Repricing. The following table sets forth certain information at December 31, 2016, regarding the dollar amount and current rates of interest for the loans maturing or repricing in the portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loan balances do not include undisbursed loan proceeds, unearned discounts, unearned income, and allowance for loan losses.

| | Real Estate | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Commercial | | Construction and Development | | Home Equity | | One-to-Four-Family[2] | | Multi-family | | Consumer | | Commercial Business | |
| Due During Years Ending December 31, | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weighted Average Rate | Amount | Weig Avera Rate |
| 2017[1] | $2,565 | 4.81% | $85,199 | 6.10% | $18,806 | 4.86% | $416 | 6.14% | $2,266 | 5.45% | $1,677 | 9.87% | $82,825 | 4.83 |
| 2018 | 2,608 | 5.69 | 4,495 | 5.79 | — | — | 1,228 | 4.39 | 1 | 5.25 | 2,086 | 7.28 | 46 | 7.49 |
| 2019 | 3,004 | 4.45 | — | — | — | — | 915 | 4.87 | 1 | 3.15 | 3,507 | 7.45 | 1,782 | 5.44 |
| 2020 and 2021 | 8,961 | 4.38 | — | — | 213 | 7.76 | 1,509 | 4.74 | 5 | 5.97 | 9,740 | 8.24 | 5,384 | 4.56 |
| 2022 to 2026 | 36,878 | 4.78 | — | — | 388 | 6.95 | 6,805 | 4.68 | 32,698 | 4.22 | 46,138 | 8.14 | 7,527 | 4.20 |
| 2027 to 2031 | 1,366 | 4.85 | 382 | 5.75 | — | — | 3,262 | 4.04 | 2,395 | 4.95 | 99,846 | 6.61 | 1,175 | 5.34 |
| 2032 and following | 489 | 6.50 | 4,386 | 4.05 | 674 | 7.54 | 109,874 | 4.10 | 161 | 5.44 | 11,732 | 6.38 | — | — |
| Total | $55,871 | 4.76% | $94,462 | 5.98% | $20,081 | 5.02% | $124,009 | 4.15% | $37,527 | 4.35% | $174,726 | 7.15% | $98,739 | 4.78 |

(1) Includes demand loans, loans having no stated maturity and overdraft loans.
(2) Excludes loans held for sale.

The total amount of loans due after December 31, 2017, which have predetermined interest rates is $231.4 million, while the total amount of loans due after this date which have floating or adjustable interest rates is $180.3 million.

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Lending Authority. The Chief Credit Officer has the authority to approve multiple loans to one borrower up to $6.0 million in aggregate. Loans in excess of $6.0 million require an additional signature from the Chief Executive Officer and/or Chief Financial Officer. All loans that are approved over $2.5 million are reported to the Asset Quality Committee ("AQC") on a monthly basis. The Chief Credit Officer may delegate lending authority to other individuals at levels consistent with their responsibilities.

The Board of Directors has implemented a lending limit policy that it believes matches the Washington State legal lending limit. At December 31, 2016, the Company's policy limits loans to one borrower and the borrower's related entities to 20% of the Bank's unimpaired capital and surplus, or $19.6 million at December 31, 2016. Management has adopted an internal lending limit of a maximum of 80% of the Bank's legal lending limit for risk mitigation purposes and all loans over this limit require approval from the AQC. The Bank's largest lending relationship at December 31, 2016, consisted of two commercial real estate loans having combined commitments of $14.0 million to two related companies. Both of these loans are secured by residential construction projects located primarily in King County, Washington, having a combined outstanding balance of $6.6 million at December 31, 2016. The second largest lending relationship consisted of two real estate secured lines of credit having combined commitments of $12.3 million to two companies. Both of these loans are secured by single family rental homes located in Snohomish and Island counties, Washington. The outstanding balance of these two lines of credit was $11.3 million at December 31, 2016. The third largest lending relationship consisted of 15 loans to eight related companies having combined commitments of $10.4 million. Seven of these loans are secured by a mix of owner and non-owner occupied commercial real estate properties located in King County, Washington, which had an aggregate outstanding balance of $8.2 million at December 31, 2016. The remaining eight loans with an aggregate outstanding balance of $1.8 million are secured by the respective borrowers' business assets. All of the loans listed above were performing in accordance with their repayment terms at December 31, 2016.

At December 31, 2016, the Company had $35.0 million approved in mortgage warehouse lending lines for six companies. The commitments ranged from $3.0 million to $9.0 million. At December 31, 2016, there was $7.8 million in warehouse lines outstanding, compared to $33.0 million approved in warehouse lending lines with $5.4 million outstanding at December 31, 2015. In addition, the Company had $49.0 million approved commercial construction warehouse lending lines for eight companies. The commitments range from $4.0 million to $9.0 million. At December 31, 2016, there was $25.1 million outstanding, compared to $25.0 million approved in commercial warehouse lending lines for five companies with $15.4 million outstanding at December 31, 2015.

Commercial Real Estate Lending. The Company offers a variety of commercial real estate loans. Most of these loans are secured by income producing properties, including multi-family residences, retail centers, warehouses and office buildings located in the market areas. At December 31, 2016, commercial real estate loans (including $37.5 million of multi-family residential loans) totaled $93.4 million, or 15.4%, of the gross loan portfolio.

The Company's loans secured by commercial real estate are originated with a fixed or variable interest rate for up to a 15-year maturity and a 30-year amortization. The variable rate loans are indexed to the prime rate of interest or a short-term LIBOR rate, or five or seven-year FHLB rate, with rates equal to the prevailing index rate to 5.0% above the prevailing rate. Loan-to-value ratios on the Company's commercial real estate loans typically do not exceed 80% of the appraised value of the property securing the loan. In addition, personal guarantees are obtained from the primary borrowers on substantially all credits.

Loans secured by commercial real estate are generally underwritten based on the net operating income of the property and the financial strength of the borrower. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt plus an additional coverage requirement. The Company generally requires an assignment of rents or leases in order to be assured that the cash flow from the project will be sufficient to repay the debt. Appraisals on properties securing commercial real estate loans are performed by independent state certified or licensed fee appraisers. The Company does not generally maintain insurance or tax escrows for loans secured by commercial real estate. In order to monitor the adequacy of cash flows on income-producing properties, the borrower is required to provide financial information on at least an annual basis.

Loans secured by commercial real estate properties generally involve a greater degree of credit risk than one-to-four-family residential mortgage loans. These loans typically involve large balances to single borrowers or groups of related borrowers. Because payments on loans secured by commercial and multi-family real estate properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired. Commercial and multi-family loans also expose a lender to greater credit risk than loans secured by one-to-four-family because the collateral securing these loans typically cannot be sold as easily as one-to-four-family. In addition, most of our commercial and multi-family loans are not fully amortizing and include balloon payments upon maturity. Balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. The largest single commercial real estate loan at December 31, 2016 was a 50% participation loan originated by another bank in the Puget Sound area. The Bank's share of the total outstanding loan at December 31, 2016 was $5.1 million, and is collateralized by commercial real estate located in King County, Washington. At December 31, 2016 this loan was performing in accordance with its repayment terms.

The Company intends to continue to emphasize commercial real estate lending and, as a result, the Company has assembled a highly experienced team, with an average of over 20 years of experience. The Bank's Chief Credit Officer and Chief Lending Officer are both senior bankers with over 25 years of commercial lending experience in the northwestern U.S. region. Management has also hired experienced commercial loan officers to support the Company's commercial real estate lending objectives. As the commercial loan portfolio expands, the Company intends to bring in additional experienced personnel in the areas of loan analysis and commercial deposit relationship management, as needed.

Construction and Development Lending. The Company expanded its residential construction lending team in 2011 with a focus on vertical, in-city one-to-four-family development in our market area. This team has over 60 years of combined experience and expertise in acquisition, development and construction ("ADC") lending in the Puget Sound market area. The Company has implemented this strategy to take advantage of what is believed to be a strong demand for construction and ADC loans to experienced, successful and relationship driven builders in our market area after many other banks abandoned this segment because of previous overexposure. At December 31, 2016, outstanding construction and development loans totaled $94.5 million, or 15.6%, of the gross loan portfolio and consisted of loans for residential and commercial construction projects, primarily for vertical construction and $3.8 million of land acquisition and development loans. Total committed, including unfunded construction and development loans at December 31, 2016, was $154.3 million. At December 31, 2016, $57.0 million, or 60.3% of our outstanding construction and development loan portfolio was comprised of speculative one-to-four-family construction loans. In addition, the Company has eight commercial secured lines of credit, secured by notes to residential construction borrowers with guarantees from principles with experience in the construction re-lending market. These loans had combined commitments of $49.0 million, and an outstanding balance of $25.1 million at December 31, 2016.

The Company's residential commercial construction lending program focuses on the origination of loans for the purpose of constructing, on both a pre-sold and speculative basis, and selling primarily one-to-four-family residences within the market area. The Company generally limits these types of loans to known builders and developers in the market area. Construction loans generally provide for the payment of interest only during the construction phase, which is typically up to 12 months. At the end of the construction phase, the construction loan is generally paid off through the sale of the newly constructed home and a permanent loan from another lender, although commitments to convert to a permanent loan may be made by us. Construction loans are generally made with a maximum loan-to-value ratio of the lower of 95% of cost or 75% of appraised value at completion. During the term of construction, the accumulated interest on the loan is typically added to the principal balance of the loan through an interest reserve of 3% to 5.5% of the loan commitment amount.

Commitments to fund construction loans generally are made subject to an appraisal of the property by an independent licensed appraiser. The Company also reviews and has a licensed third-party inspect each property before disbursement of funds during the term of the construction loan. Loan proceeds are disbursed after inspection by a third party inspector based on the percentage of completion method.

The Company may also make land acquisition and development loans to builders or residential lot developers on a limited basis. These loans involve a higher degree of credit risk, similar to commercial construction loans. At December 31, 2016, included in the $94.5 million of construction and development loans, were six residential land acquisition and development loans for finished lots totaling $3.8 million, with total commitments of $6.9 million. These land loans also involve additional risks because the loan amount is based on the projected value of the lots after development. Loans are made for up to 75% of the estimated value with a term of up to two years. These loans are required to be paid on an accelerated basis as the lots are sold, so that the Company is repaid before all the lots are sold. Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate.

Construction and development lending contains the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. Changes in the demand, such as for new housing and higher than anticipated building costs may cause actual results to vary significantly from those estimated. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. This type of lending also typically involves higher loan principal amounts and is often concentrated with a small number of builders. In addition, during the term of most of our construction loans, an interest reserve is created at origination and is added to the principal of the loan through the construction phase. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. Because construction loans require active monitoring of the building process, including cost comparisons and on-site inspections, these loans are more difficult and costly to monitor.

Increases in market rates of interest may have a more pronounced effect on construction loans by rapidly increasing the end-purchasers' borrowing costs, thereby reducing the overall demand for the project. Properties under construction are often difficult to sell and typically must be completed in order to be successfully sold which also complicates the process of working out problem construction loans. This may require us to advance additional funds and/or contract with another builder to complete construction. Furthermore, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk than construction loans to individuals on their personal residences as there is the added risk associated with identifying an end-purchaser for the finished project. Loans on land under development or held for future construction pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor themselves to repay principal and interest.

The Company seeks to address the forgoing risks associated with construction development lending by developing and adhering to underwriting policies, disbursement procedures and monitoring practices. Specifically, the Company (i) seeks to diversify the number of loans and projects in the market area, (ii) evaluate and document the creditworthiness of the borrower and the viability of the proposed project, (iii) limit loan-to-value ratios to specified levels, (iv) control disbursements on construction loans on the basis of on-site inspections by a licensed third-party, and (v) monitor economic conditions and the housing inventory in each market. No assurances, however, can be given that these practices will be successful in mitigating the risks of construction development lending.

Home Equity Lending. The Company has been active in second mortgage and home equity lending, with the focus of this lending being conducted in the Company's primary market area. The home equity lines of credit generally have adjustable rates tied to the prime rate of interest with a draw term of ten years plus and a term to maturity of 15 years. Monthly payments are based on 1.0% of the outstanding balance with a maximum combined loan-to-value ratio of up to 90%, including any underlying first mortgage. Second mortgage home equity loans are typically fixed rate, amortizing loans with terms of up to 15 years. Total second mortgage/home equity loans totaled $20.1 million, or 3.3% of the gross loan portfolio, at December 31, 2016, $18.4 million of which were adjustable rate home equity lines of credit. Unfunded commitments on loans and lines of credit at December 31, 2016, was $26.1 million.

Residential. The Company originates loans secured by first mortgages on one-to-four-family residences primarily in the market area. 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 $770.2 million of one-to-four-family consumer mortgages and sold $711.7 million to investors in 2016. Of the loans sold to investors, $452.7 million were sold to

Fannie Mae, Ginnie Mae, FHLB, and/or Freddie Mac with servicing rights retained in order to further build the relationship with the customer. At December 31, 2016, one-to-four-family residential mortgage loans totaled $124.0 million, or 20.5%, of the gross loan portfolio, excluding loans held for sale of $52.6 million. In addition, the Company originated $3.8 million in residential loans through our commercial lending channel, secured by single family rental homes in Washington, with combined commitments of $12.3 million, and an outstanding balance of $11.3 million at

December 31, 2016 that are not included in our one-to-four-family residential mortgage loan portfolio. See "Commercial Business Lending."

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 will lend 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 generally pose different credit risks than fixed-rate loans, primarily because as interest rates rise 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 overlays as determined by the internal underwriting department.

Consumer Lending. Consumer lending represents a significant and important historical activity for the Company, primarily reflecting the indirect lending through home improvement contractors and dealers. At December 31, 2016, consumer loans totaled $174.7 million, or 28.9% of the gross loan portfolio.

The Company's indirect home improvement loans, also referred to as fixture secured loans, represent the largest portion of the consumer loan portfolio and have traditionally been the mainstay of the Company's lending strategy. These loans totaled $107.8 million, or 17.8% of the gross loan portfolio, and 61.7% of total consumer loans, at December 31, 2016. Indirect home improvement loans are originated through a network of 115 home improvement contractors and dealers located in Washington, Oregon, Idaho, and California. Four dealers are responsible for a majority (50.5%) of the loan volume. These fixture secured loans consist of loans for a wide variety of products, such as replacement windows, siding, roofs, HVAC systems, and roofing materials.

In order to grow the Company's indirect home improvement loan volume, the Company expanded into the State of California in 2012 with a limited number of contractors and dealers of solar loans. Solar loans are the second largest portion of the consumer loan portfolio which totaled $36.5 million, or 6.0% of the gross loan portfolio. As of December 31, 2016, the Company had $36.2 million in loans to borrowers that reside in California, or 99.2% of total solar loans, 20.7% of total consumer loans. The Company's primary home improvement focus in California is on consumer solar panel installations which comprise 99.2% of the volume originated in California.

In connection with fixture secured and solar loans, the Company receives loan applications from the dealers, and originates the loans based on pre-defined lending criteria. The loans are processed through the loan origination software, with approximately 20% of the loan applications receiving an automated approval based on the information provided, and the remaining loans processed by the Company's credit analysts. The Company follows the internal underwriting guidelines in evaluating loans obtained through the indirect dealer program, including using a Fair Isaac and Company, Incorporated ("FICO"), credit score to approve loans. A FICO score is a principal measure of credit quality and is one of the significant criteria we rely upon in our underwriting in addition to the borrower's debt to income.

The Company's fixture secured and solar loans generally range in amounts from $2,500 to $50,000, and generally carry terms of 12 to 20 years with fixed rates of interest. In some instances, the participating dealer may pay a fee to buy down the borrower's interest rate to a rate below the Company's published rate. Fixture secured and solar loans 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. The Company generally files a UCC-2 financing statement to perfect the security interest in the personal property in situations where the borrower's credit score is below 720 or the home improvement loan is for an amount in excess of $5,000. Perfection gives the Company a claim to the collateral that is superior to someone that obtains a lien through the judicial process subsequent to the perfection of a security interest. The failure to perfect a security interest does not render the security interest unenforceable against the borrower. However, failure to perfect a security interest risks avoidance of the security interest in bankruptcy or subordination to the claims of third parties.

The Company also offers consumer marine loans secured by boats. Marine loans represent the third largest segment of the consumer loan portfolio. As of December 31, 2016, the marine loan portfolio totaled $28.5 million, or

4.7% of the gross loan portfolio and 16.3% of total consumer loans. Marine loans are originated with borrowers on both a direct and indirect basis, and generally carry terms of up to 20 years with fixed rates of interest. The Company requires a 10% down payment, and the loan amount may be up to the lesser of 120% of factory invoice or 90% of the purchase price.

The Company originates other consumer loans which totaled $1.9 million as of December 31, 2016. These loans primarily include personal lines of credit, automobile, direct home improvement, loans on deposit, and recreational loans.

In evaluating any consumer loan application, a borrower's FICO score is utilized as an important indicator of credit risk. The FICO score represents the creditworthiness of a borrower based on the borrower's credit history, as reported by an independent third party. A higher FICO score typically indicates a greater degree of creditworthiness. Over the last several years the Company has emphasized originations of loans to consumers with higher credit scores. This has resulted in a lower level of loan charge-offs in recent periods. As of December 31, 2016, 71.2% of the consumer loan portfolio was originated with borrowers having a FICO score over 720 at the time of origination, and 95.6% was originated with borrowers having a FICO score over 660 at the time of origination. Generally, a FICO score of 660 or higher indicates the borrower has an acceptable credit reputation. A credit score at the time of loan origination of less than 660 is considered "subprime" by federal banking regulators. Borrowers of our one-to-four-family loans had an average FICO score of 725 at the time of loan origination. Consideration for loans with FICO scores below 660 require additional management oversight and approval.

Consumer loans generally have shorter terms to maturity, which reduces the Company's exposure to changes in interest rates. In addition, management believes that offering consumer loan products helps to expand and create stronger ties to existing customer base by increasing the number of customer relationships and providing cross-marketing opportunities.

Consumer and other loans generally entail greater risk than do one-to-four-family residential mortgage loans, particularly in the case of consumer loans that are secured by rapidly depreciable assets, such as boats, automobiles and other recreational vehicles. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, consumer loan collections are dependent on the borrower's continuing financial stability and, thus, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. In the case of fixture secured and solar loans, it is very difficult to repossess the personal property securing these loans as they are typically attached to the borrower's personal residence. Accordingly, if a borrower defaults on a fixture secured or solar loan the only practical recourse is to wait until the borrower wants to sell or refinance the home, at which time if there is a perfected security interest the Company generally will be able to collect a percentage of the loan previously charged off.

Commercial Business Lending. The Company originates commercial business loans and lines of credit to local small- and mid-sized businesses in the Puget Sound market area that are secured by accounts receivable, inventory or property, plant and equipment. Consistent with management's objectives to expand commercial business lending, in 2009, the Company commenced a mortgage warehouse lending program through which the Company funds third-party mortgage bankers. Under this program the Company provides short term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. The Company's warehouse lending lines are secured by the underlying notes associated with one-to-four-family mortgage loans made to borrowers by the mortgage banking company and generally require guarantees from the principal shareholder(s) of the mortgage banking company. These loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down the outstanding loan before being dispersed to the mortgage bank. The Company also has construction warehouse lines secured by notes on construction loans and guaranteed by principles with experience in construction lending. At December 31, 2016, the Company had $35.0 million approved in mortgage warehouse lending lines for six companies. The commitments ranged from $3.0 million to $9.0 million. At December 31, 2016, there was $7.8 million in warehouse lines outstanding, compared to $33.0 million approved in warehouse lending lines with $5.4 million outstanding at December 31, 2015. In addition, the Company had $49.0

million approved commercial construction warehouse lending lines for eight companies. The commitments range from $4.0 million to $9.0 million. At December 31, 2016, there was $25.1 million outstanding, compared to $25.0 million approved in commercial warehouse lending lines for five companies with $15.4 million outstanding at December 31, 2015.

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Commercial business loans may be fixed-rate, but are usually adjustable-rate loans indexed to the prime rate of interest, plus a margin. Some of the commercial business loans, such as those made pursuant to the warehouse lending program, are structured as lines of credit with terms of 12 months and interest only payments required during the term, while other loans may reprice on an annual basis and amortize over a two to five year period. Due to the current interest rate environment, these loans and lines of credit are generally originated with a floor, which is generally set between 3.5% and 5.5%. Loan fees are generally charged at origination depending on the credit quality and account relationships of the borrower. Advance rates on these types of lines are generally limited to 80% of accounts receivable and 50% of inventory. The Company also generally requires the borrower to establish a deposit relationship as part of the loan approval process. At December 31, 2016, the commercial business loan portfolio totaled $98.7 million, or 16.3%, of the gross loan portfolio including warehouse lending loans.

At December 31, 2016, most of the commercial business loans were secured. The Company's commercial business lending policy includes credit file documentation and analysis of the borrower's background, capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as an evaluation of other conditions affecting the borrower. Analysis of the borrower's past, present and future cash flows is also an important aspect of credit analysis. The Company generally requires personal guarantees on commercial business loans. Nonetheless, commercial business loans are believed to carry higher credit risk than residential mortgage loans. The two largest commercial business lending relationships consisted of two commercial lines of credit to two related companies, and two real estate secured lines of credit to two related companies. The first two commercial lines of credit, secured by notes for residential construction projects located primarily in King County, Washington, have combined commitments of $14.0 million, and an outstanding balance of $6.6 million at December 31, 2016. These loans are classified as construction warehouse loans and included in our warehouse lending program. The other two real estate secured lines of credit, secured by single family rental homes located in Snohomish and Island counties, Washington, have combined commitments of $12.3 million, and an outstanding balance of $11.3 million at December 31, 2016.

Unlike residential mortgage loans, commercial business loans, particularly unsecured loans, are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business and, therefore, are of higher risk. The Company makes commercial loans secured by business assets, such as accounts receivable, inventory, equipment, real estate and cash as collateral with loan-to-value ratios in most cases up to 80%, based on the type of collateral. This collateral depreciates over time, may be difficult to appraise and may fluctuate in value based on the specific type of business and equipment used. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself (which, in turn, is often dependent in part upon general economic conditions).

Loan Originations, Servicing, Purchases and Sales

The Company originates both fixed-rate and adjustable-rate loans. The ability to originate loans, however, is dependent upon customer demand for loans in the market areas. From time to time to supplement our loan originations and based on our asset/liability objectives we will also purchase bulk loans or pools of loans from other financial institutions.

Over the past few years, the Company has continued to originate consumer loans, and increased emphasis on commercial real estate loans, including construction and development lending, as well as commercial business loans. Demand is affected by competition and the interest rate environment. In periods of economic uncertainty, the ability of financial institutions, including us, to originate large dollar volumes of commercial business and real estate loans may be substantially reduced or restricted, with a resultant decrease in interest income. In addition to interest earned on loans and loan origination fees, the Company receives fees for loan commitments, late payments and other miscellaneous services. The fees vary from time to time, generally depending on the supply of funds and other competitive conditions in the market.

The Company will sell long-term, fixed-rate residential real estate loans in the secondary market to mitigate interest rate risk. These loans are generally sold for cash in amounts equal to the unpaid principal amount of the loans determined using present value yields to the buyer. These sales allowed for a servicing fee on loans when the servicing is retained by the Company. A majority of residential real estate loans sold by the Company were sold with servicing retained. The Company earned gross mortgage servicing fees of $2.0 million for the year ended December 31, 2016. At December 31, 2016, the Company was servicing $973.5 million of one-to-four-family loans for Federal National

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Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association, and Federal Home Loan Bank. These mortgage servicing rights constituted a $8.5 million asset on the books on that date, which is amortized in proportion to and over the period of the net servicing income. These mortgage servicing rights are periodically evaluated for impairment based on their fair value, which takes into account the rates and potential prepayments of those sold loans being serviced. The fair value of the servicing rights at December 31, 2016 was $11.7 million. See Notes 5 and 15 of the Notes to Consolidated Financial Statements included in Item 8, “Financial Statements and Supplementary Data” of this Form 10-K.

The following table presents the activity during the year ended December 31, 2016, related to loans serviced for others.

| Beginning balance at January 1, 2016 | (In thousands) |
|---|---|
| One-to-four-family | $631,940 |
| Consumer | 2,191 |
| Commercial business | 1,988 |
| Subtotal | 636,119 |
| Additions | |
| One-to-four-family | 452,655 |
| Repayments | |
| One-to-four-family | (111,054) |
| Consumer | (563) |
| Commercial business | (39) |
| Subtotal | (111,656) |
| Ending balance at December 31, 2016 | |
| One-to-four-family | 973,541 |
| Consumer | 1,628 |
| Commercial business | 1,949 |
| Total | $977,118 |

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The following table shows total loans originated, purchased, sold and repaid during the years indicated.

| (In thousands) | Years Ended December 31, | |
|---|---|---|
| Originations by type: | 2016 | 2015 |
| Fixed-rate: | | |
| Commercial | $9,812 | $5,172 |
| Home equity | 2,504 | 1,256 |
| One-to-four-family (1) | 3,990 | 3,309 |
| Loans held for sale (one-to-four-family) | 704,366 | 531,460 |
| Multi-family | 2,061 | 784 |
| Consumer | 84,039 | 79,789 |
| Commercial business (excluding warehouse lines) | 21,830 | 4,709 |
| Total fixed-rate | 828,602 | 626,479 |
| Adjustable- rate: | | |
| Commercial | 10,224 | 9,691 |
| Construction and development | 73,730 | 126,095 |
| Home equity | 12,793 | 8,498 |
| One-to-four-family (1) | 51,136 | 54,992 |
| Loans held for sale (one-to-four-family) | 14,498 | 40,285 |
| Multi-family | 15,209 | 7,001 |
| Consumer | 1,484 | 973 |
| Commercial business (excluding warehouse lines) | 104,073 | 65,695 |
| Warehouse lines, net | 2,416 | (4,685) |
| Total adjustable-rate | 285,563 | 308,545 |
| Total loans originated | 1,114,165 | 935,024 |
| Purchases by type: | | |
| Adjustable-rate: | | |
| One-to-four-family (1) | — | 16,255 |
| Total loans purchased | — | 16,255 |
| Sales and repayments: | | |
| Commercial | (111) | — |
| Loans held for sale (one-to-four-family) | (711,698) | (551,455) |
| Consumer | — | — |
| Total loans sold | (711,809) | (551,455) |
| Total principal repayments | (300,595) | (263,810) |
| Total reductions | (1,012,404) | (815,265) |
| Net increase | $101,761 | $136,014 |

(1) One-to-four-family portfolio loans.

Sales of whole real estate loans and participations in real estate loans can be beneficial to us since these sales systematically generate income at the time of sale, produce future servicing income on loans where servicing is retained, provide funds for additional lending and other investments, and increase liquidity.

Sales of whole consumer loans, specifically longer term consumer loans, can be beneficial to us since these sales generate income at the time of sale, can potentially create future servicing income where servicing is retained, and provide a mitigation of interest rate risk associated with holding 15-20 year maturity consumer loans.

Asset Quality

When a borrower fails to make a required payment on a residential real estate loan, the Company attempts to cure the delinquency by contacting the borrower. In the case of loans secured by residential real estate, a late notice typically is sent 16 days after the due date, and the borrower is contacted by phone within 16 to 25 days after the due date. When the loan is 30 days past due, an action plan is formulated for the credit under the direction of the Loan Control department manager. Generally, a delinquency letter is mailed to the borrower. All delinquent accounts are reviewed by a loan control representative who attempts to cure the delinquency by contacting the borrower once the loan is 30 days past due. If the account becomes 60 days delinquent and an acceptable repayment plan has not been

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agreed upon, a loan control representative will generally refer the account to legal counsel with instructions to prepare a notice of intent to foreclose. The notice of intent to foreclose allows the borrower up to 30 days to bring the account current. Between 90 - 120 days past due, a value is obtained for the loan collateral. At that time, a mortgage analysis is completed to determine the loan-to-value ratio and any collateral deficiency. If foreclosed, the Company customarily takes title to the property and sells it directly through a real estate broker.

Delinquent consumer loans are handled in a similar manner. Appropriate action is taken in the form of phone calls and notices to collect any loan payment that is delinquent more than 16 days. Once the loan is 90 days past due, it is classified as non-accrual. Generally, credits are charged off if past due 120 days, unless the collections department provides support for a customer repayment plan. Bank procedures for repossession and sale of consumer collateral are subject to various requirements under the applicable consumer protection laws as well as other applicable laws and the determination by us that it would be beneficial from a cost basis.

Delinquent commercial business loans and loans secured by commercial real estate are handled by the loan officer in charge of the loan, who is responsible for contacting the borrower. The loan officer works with outside counsel and, in the case of real estate loans, a third party consultant to resolve problem loans. In addition, management meets as needed and reviews past due and classified loans, as well as other loans that management feels may present possible collection problems, which are reported to the loan committee and the board on a monthly basis. If an acceptable workout of a delinquent commercial loan cannot be agreed upon, the Company customarily will initiate foreclosure or repossession proceedings on any collateral securing the loan.

The following table shows delinquent loans by the type of loan and number of days delinquent at December 31, 2016. Categories not included in the table below did not have any delinquent loans at December 31, 2016.

| | Loans Delinquent For: | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | 60-89 Days | | | 90 Days or More | | | Total Loans Delinquent 60 Days or More | | |
| Real estate loans | Number | Amount | Percent of Loan Category | Number | Amount | Percent of Loan Category | Number | Amount | Percent of Loan Category |
| Home equity | — | $ — | — % | 5 | $ 210 | 1.05 % | 5 | $ 210 | 1.05 % |
| Total real estate loans | — | — | — | 5 | 210 | 0.06 | 5 | 210 | 0.06 |
| Consumer loans | | | | | | | | | |
| Indirect home improvement | 31 | 278 | 0.26 | 20 | 167 | 0.15 | 51 | 445 | 0.41 |
| Solar | — | — | — | 2 | 69 | 0.19 | 2 | 69 | 0.19 |
| Other consumer | 2 | 2 | 0.10 | 2 | 4 | 0.21 | 4 | 6 | 0.31 |
| Total consumer loans | 33 | 280 | 0.16 | 24 | 240 | 0.14 | 57 | 520 | 0.30 |
| Total | 33 | $ 280 | 0.05 % | 29 | $ 450 | 0.07 % | 62 | $ 730 | 0.12 % |

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Non-performing Assets. The following table sets forth information with respect to the Company's non-performing assets.

| (Dollars in thousands) | December 31, | | | | |
|---|---|---|---|---|---|
| Non-accruing loans: | 2016 | 2015 | 2014 | 2013 | 2012 |
| Real estate loans | | | | | |
| Commercial | $— | $— | $— | $567 | $783 |
| Home equity | 210 | 47 | 61 | 172 | 248 |
| One-to-four-family | — | 525 | 73 | 104 | 344 |
| Total real estate loans | 210 | 572 | 134 | 843 | 1,375 |
| Consumer loans | | | | | |
| Indirect home improvement | 435 | 408 | 250 | 258 | 295 |
| Solar | 69 | 37 | 29 | — | — |
| Marine | — | — | 19 | — | — |
| Other consumer | 7 | — | 1 | — | 42 |
| Total consumer loans | 511 | 445 | 299 | 258 | 337 |
| Commercial business loans | | | | | |
| Commercial and industrial | — | — | — | — | 194 |
| Total Commercial business loans | — | — | — | — | 194 |
| Total non-accruing loans | 721 | 1,017 | 433 | 1,101 | 1,906 |
| Accruing loans contractually past due 90 days or more | — | — | — | — | — |
| Real estate owned | — | — | — | 2,075 | 2,127 |
| Repossessed consumer property | 15 | — | — | 32 | 31 |
| Total non-performing assets | $736 | $1,017 | $433 | $3,208 | $4,064 |
| Restructured loans | $57 | $734 | $783 | $815 | $3,260 |
| Total non-performing assets as a percentage of total assets | 0.09 % | 0.15 % | 0.08 % | 0.77 % | 1.13 % |

For the year ended December 31, 2016, gross interest income which would have been recorded had the non-accruing loans been current in accordance with their original terms was $8,000. Prior to non-accrual status, the amount of interest income included in net income for the year ended December 31, 2016 was $47,000 for these loans.

Real Estate Owned. Real estate acquired by the Company as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate owned until it is sold. When the property is acquired, it is recorded at the lower of its cost, which is the unpaid principal balance of the related loan plus foreclosure costs, or the fair market value of the property less selling costs. The Company had no real estate owned properties as of December 31, 2016.

Restructured Loans. According to generally accepted accounting principles in the United States of America ("U.S. GAAP"), the Company is required to account for certain loan modifications or restructuring as a "troubled debt restructuring." In general, the modification or restructuring of a debt is considered a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrowers that would not otherwise be considered. The Company had one restructured loan at December 31, 2016, of $57,000 that was performing in accordance with its modified terms.

Other Assets Especially Mentioned. At December 31, 2016, there were no loans with respect to which known information about the possible credit problems of the borrowers caused management to have doubts as to the ability of the borrowers to comply with present loan repayment terms and which may result in the future inclusion of such items in the non-performing asset categories.

Classified Assets. Federal regulations provide for the classification of lower quality loans and other assets (such as other real estate owned and repossessed property), debt and equity securities, as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and pay capacity of the

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borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

When the Company classifies problem assets as either substandard or doubtful, a specific allowance may be established in an amount deemed prudent to address specific impairments. General allowances represent loss allowances 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 assets. When an insured institution classifies problem assets as a loss, it is required to charge off those assets in the period in which they are deemed uncollectible. The Company's determination as to the classification of assets and the amount of valuation allowances is subject to review by the FDIC and the DFI, which can order the establishment of additional loss allowances. Assets which do not currently expose the Company to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated as special mention.

In connection with the filing of periodic reports with the FDIC and in accordance with the Company's classification of assets policy, the Company regularly reviews the problem assets in the portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of the review of the Company's assets, at December 31, 2016, the Company had classified $8.0 million of assets as substandard. The $8.0 million of classified assets represented 9.9% of equity and 1.0% of total assets at December 31, 2016. The Company had no assets classified as special mention at December 31, 2016.

Allowance for Loan Losses

The Company maintains an allowance for loan losses to absorb probable incurred credit losses in the loan portfolio. The allowance is based on ongoing, monthly assessments of the estimated probable incurred losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers the types of loans and the amount of loans in the loan portfolio, peer group information, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. Large groups of smaller balance homogeneous loans, such as residential real estate, small commercial real estate, home equity and consumer loans, are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions. More complex loans, such as commercial real estate loans and commercial business loans, are evaluated individually for impairment, primarily through the evaluation of net operating income and available cash flow and their possible impact on collateral values.

The allowance is increased by the provision for loan losses, which is charged against current period earnings and decreased by the amount of actual loan charge-offs, net of recoveries.

The provision for loan losses was $2.4 million for the year ended December 31, 2016. The allowance for loan losses was $10.2 million, or 1.7% of gross loans receivable at December 31, 2016, as compared to $7.8 million, or 1.5% of gross loans receivable outstanding at December 31, 2015. The level of the allowance is based on estimates, and the ultimate losses may vary from the estimates. Management will continue to review the adequacy of the allowance for loan losses and make adjustments to the provision for loan losses based on loan growth, economic conditions, charge-offs and portfolio composition.

Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, reflects probable incurred loan losses in the loan portfolio. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations - Comparison of Results of Operations for the Years Ended December 31, 2016 and 2015 - Provision for Loan Losses" and Notes 1 and 4 of the Notes to Consolidated Financial Statements included in Item 8, "Financial Statements and Supplementary Data" of this Form 10-K.

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The following table summarizes the distribution of the allowance for loan losses by loan category.

| (Dollars in thousands) | December 31, 2016 | | | 2015 | | | 2014 | | | 2013 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Allocated at end of year to: | Loan balance | Percent of loan balance in each category to total loans | Allowance for loan losses by loan category | Loan balance | Percent of loan balance in each category to total loans | Allowance for loan losses by loan category | Loan balance | Percent of loan balance in each category to total loans | Allowance for loan losses by loan category | Loan balance | Percent of loan balance in each category to total loans |
| Real estate loans | | | | | | | | | | | |
| Commercial | $55,871 | 9.23 % | $708 | $50,034 | 9.78 % | $514 | $42,970 | 10.90 % | $559 | $32,970 | 11.48 % |
| Construction and development | 94,462 | 15.60 | 1,273 | 80,806 | 15.80 | 1,157 | 57,813 | 14.67 | 675 | 41,633 | 14.49 |
| Home equity | 20,081 | 3.32 | 244 | 16,540 | 3.24 | 222 | 15,737 | 3.99 | 187 | 15,172 | 5.28 |
| One-to-four-family | 124,009 | 20.48 | 947 | 102,921 | 20.13 | 770 | 46,801 | 11.87 | 303 | 20,809 | 7.25 |
| Multi-family | 37,527 | 6.20 | 375 | 22,223 | 4.35 | 211 | 16,201 | 4.11 | 143 | 4,682 | 1.63 |
| Total real estate loans | 331,950 | 54.83 | 3,547 | 272,524 | 53.30 | 2,874 | 179,522 | 45.54 | 1,867 | 115,266 | 40.13 |
| | | | | | | | | | | | |
| Consumer loans | | | | | | | | | | | |
| Indirect home improvement | 107,759 | 17.80 | 1,404 | 103,064 | 20.16 | 1,157 | 99,304 | 25.19 | 1,146 | 91,167 | 31.74 |
| Solar | 36,503 | 6.03 | 407 | 29,226 | 5.72 | 299 | 18,162 | 4.61 | 137 | 16,838 | 5.86 |
| Marine | 28,549 | 4.71 | 229 | 23,851 | 4.66 | 192 | 16,713 | 4.24 | 108 | 11,203 | 3.90 |
| Other consumer | 1,915 | 0.32 | 42 | 2,181 | 0.43 | 33 | 2,628 | 0.66 | 40 | 3,498 | 1.22 |
| Total consumer loans | 174,726 | 28.86 | 2,082 | 158,322 | 30.97 | 1,681 | 136,807 | 34.70 | 1,431 | 122,706 | 42.72 |
| | | | | | | | | | | | |
| Commercial business loans | | | | | | | | | | | |
| Commercial and industrial | 65,841 | 10.88 | 2,297 | 59,619 | 11.66 | 1,035 | 55,624 | 14.11 | 849 | 45,242 | 15.75 |
| Warehouse lending | 32,898 | 5.43 | 378 | 20,817 | 4.07 | 361 | 22,257 | 5.65 | 340 | 4,002 | 1.40 |
| Total commercial business loans | 98,739 | 16.31 | 2,675 | 80,436 | 15.73 | 1,396 | 77,881 | 19.76 | 1,189 | 49,244 | 17.15 |
| Unallocated reserve | — | — | 1,907 | — | — | 1,834 | — | — | 1,603 | — | — |
| Total | $605,415 | 100.00 % | $10,211 | $511,282 | 100.00 % | $7,785 | $394,210 | 100.00 % | $6,090 | $287,216 | 100.00 % |

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The following table sets forth an analysis of the allowance for loan losses at the dates and or the periods indicated.

| (Dollars in thousands) | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| Balance at beginning of year | $7,785 | $6,090 | $5,092 | $4,698 | $4,345 |
| Charge-offs: | | | | | |
| Real estate loans | | | | | |
| Commercial | — | 191 | 120 | 340 | 48 |
| Construction and development | — | — | — | 194 | 94 |
| Home equity | 65 | 57 | 94 | 257 | 381 |
| One-to-four-family | — | — | — | 18 | 257 |
| Total real estate loans | 65 | 248 | 214 | 809 | 780 |
| Consumer loans | | | | | |
| Indirect home improvement | 822 | 1,265 | 1,341 | 1,562 | 2,156 |
| Solar | 50 | 92 | — | — | — |
| Marine | 81 | 63 | 15 | 43 | — |
| Other consumer | 49 | 46 | 51 | 152 | 425 |
| Total consumer loans | 1,002 | 1,466 | 1,407 | 1,757 | 2,581 |
| Commercial business loans | | | | | |
| Commercial and industrial | — | 40 | 75 | 63 | 179 |
| Total commercial business loans | — | 40 | 75 | 63 | 179 |
| Total charge-offs | 1,067 | 1,754 | 1,696 | 2,629 | 3,540 |
| Recoveries: | | | | | |
| Real estate loans | | | | | |
| Commercial | — | 191 | — | 38 | — |
| Home equity | 68 | 33 | 80 | 35 | 9 |
| One-to-four-family | 48 | — | 104 | 18 | — |
| Total real estate loans | 116 | 224 | 184 | 91 | 9 |
| Consumer loans | | | | | |
| Indirect home improvement | 780 | 870 | 630 | 510 | 630 |
| Marine | 29 | 33 | 13 | 17 | — |
| Other consumer | 81 | 56 | 65 | 219 | 322 |
| Total consumer loans | 890 | 959 | 708 | 746 | 952 |
| Commercial business loans | | | | | |
| Commercial and industrial | 87 | 16 | 2 | 16 | 19 |
| Total commercial business loans | 87 | 16 | 2 | 16 | 19 |
| Total recoveries | 1,093 | 1,199 | 894 | 853 | 980 |
| Net (recoveries) charge-offs | (26) | 555 | 802 | 1,776 | 2,560 |
| Additions charged to operations | 2,400 | 2,250 | 1,800 | 2,170 | 2,913 |
| Balance at end of year | $10,211 | $7,785 | $6,090 | $5,092 | $4,698 |
| Net (recoveries) charge-offs to average loans outstanding | — % | 0.11 % | 0.24 % | 0.63 % | 1.03 % |
| Net (recoveries) charge-offs to average non-performing assets | (3.00)% | 76.55 % | 44.04 % | 48.84 % | 46.72 % |
| Allowance as a percentage of non-performing loans | 1,416.23 % | 765.49 % | 1,406.47 % | 462.49 % | 246.48 % |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Allowance as a percentage of gross loans receivable (end of year) | 1.69 | % | 1.52 | % | 1.54 | % | 1.77 | % | 1.68 | % |

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While management believes that the estimates and assumptions used in its determination of the adequacy of the allowance for loan losses are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the Company's financial condition and results of operations. In addition, the determination of the amount of the Bank's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

Investment Activities

General. Under Washington law, savings banks are permitted to invest in various types of liquid assets, including U.S. Treasury obligations, securities of various federal agencies, certain certificates of deposit of insured banks and savings institutions, banker's acceptances, repurchase agreements, federal funds ("Fed Funds"), commercial paper, investment grade corporate debt securities, and obligations of states and their political subdivisions.

The Chief Financial Officer has the responsibility for the management of the Company's investment portfolio, subject to consultation with the Chief Executive Officer, and the direction and guidance of the Board of Directors. Various factors are considered when making investment decisions, including the marketability, maturity and tax consequences of the proposed investment. The maturity structure of investments will be affected by various market conditions, including the current and anticipated slope of the yield curve, the level of interest rates, the trend of new deposit inflows, and the anticipated demand for funds via deposit withdrawals and loan originations and purchases.

The general objectives of the Company's investment portfolio will be to provide liquidity when loan demand is high, to assist in maintaining earnings when loan demand is low and to maximize earnings while satisfactorily managing risk, including credit risk, reinvestment risk, liquidity risk and interest rate risk. See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management and Market Risk" of this Form 10-K.

As a member of the FHLB of Des Moines, the Bank had $2.7 million in stock at December 31, 2016. For the year ended December 31, 2016, the Bank received $50,000 in dividends from the FHLB of Des Moines.

The table below sets forth information regarding the composition of the securities portfolio and other investments at the dates indicated. At December 31, 2016, the securities portfolio did not contain securities of any issuer with an aggregate book value in excess of 10% of equity capital, excluding those issued by the United States Government or its agencies.

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| (In thousands) | 2016 | | 2015 | | 2014 | |
| Securities available-for-sale | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| U.S. agency securities | $8,150 | $8,068 | $6,134 | $6,035 | $5,998 | $5,845 |
| Corporate securities | 7,654 | 7,500 | 3,495 | 3,433 | 4,495 | 4,437 |
| Municipal bonds | 15,183 | 15,264 | 18,531 | 18,891 | 15,886 | 16,161 |
| Mortgage-backed securities | 45,856 | 45,195 | 22,926 | 22,835 | 20,169 | 20,244 |
| U.S. Small Business Administration securities | 5,862 | 5,848 | 4,011 | 4,023 | 2,019 | 2,057 |
| Total securities available-for-sale | $82,705 | $81,875 | $55,097 | $55,217 | $48,567 | $48,744 |

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The composition and contractual maturities of the investment portfolio at December 31 2016, excluding FHLB stock, are indicated in the following table. The yields on municipal bonds have not been computed on a tax equivalent basis.

| | December 31, 2016 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | 1 year or less | | Over 1 year to 5 years | | Over 5 to 10 years | | Over 10 years | | Total Securities | | |
| Securities available-for-sale | Amortized Cost | Weighted Average Yield | Amortized Cost | Weighted Average Yield | Amortized Cost | Weighted Average Yield | Amortized Cost | Weighted Average Yield | Amortized Cost | Weighted Average Yield | Fair Value |
| U.S. agency securities | $— | — % | $4,000 | 1.60 % | $4,150 | 2.33 % | $— | — % | $8,150 | 1.97 % | $8,068 |
| Corporate securities | — | — | 5,659 | 2.09 | 1,995 | 1.88 | — | — | 7,654 | 2.04 | 7,500 |
| Municipal bonds | 509 | 1.95 | 5,326 | 2.21 | 7,476 | 2.17 | 1,872 | 2.81 | 15,183 | 2.26 | 15,264 |
| Mortgage-backed securities | — | — | — | — | 7,754 | 2.39 | 38,102 | 2.10 | 45,856 | 2.15 | 45,195 |
| U.S. Small Business Administration securities | — | — | — | — | 5,862 | 2.60 | — | — | 5,862 | 2.60 | 5,848 |
| Total securities available-for-sale | $509 | 1.95 % | $14,985 | 2.00 % | $27,237 | 2.33 % | $39,974 | 2.13 % | $82,705 | 2.17 % | $81,875 |

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Deposit Activities and Other Sources of Funds

General. Deposits, borrowings, and loan repayments are the major sources of funds for lending and other investment purposes. Scheduled loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced significantly by general interest rates and market conditions. Borrowings from the FHLB of Des Moines are used to supplement the availability of funds from other sources and also as a source of term funds to assist in the management of interest rate risk.

The Company's deposit composition reflects a mixture with certificates of deposit accounting for 27.5% of the total deposits at December 31, 2016, and interest and noninterest-bearing checking, savings and money market accounts comprising the balance of total deposits. The Company relies on marketing activities, convenience, customer service and the availability of a broad range of deposit products and services to attract and retain customer deposits. The Company also had $47.1 million of brokered deposits, or 6.6% of total deposits at December 31, 2016, with original terms averaging four years which were used to manage interest rate risk.

Deposits. Deposits are attracted from within the market area through the offering of a broad selection of deposit instruments, including checking accounts, money market deposit accounts, savings accounts and certificates of deposit with a variety of rates. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of the Company's deposit accounts, the Company considers the development of long term profitable customer relationships, current market interest rates, current maturity structure and deposit mix, customer preferences and the profitability of acquiring customer deposits compared to alternative sources.

The following table sets forth total deposit activities for the years indicated.

| | Years Ended December 31, | | |
|---|---|---|---|
| (Dollars in thousands) | 2016 | 2015 | 2014 |
| Beginning balance | $485,178 | $420,444 | $336,876 |
| Net deposits before interest credited | 224,161 (1) | 61,505 | 81,134 |
| Interest credited | 3,254 | 3,229 | 2,434 |
| Ending balance | $712,593 | $485,178 | $420,444 |
| | | | |
| Net increase in deposits | $227,415 | $64,734 | $83,568 |
| Percent increase | 46.87 % | 15.40 % | 24.81 % |

(1) On January 22, 2016, the Company completed the previously announced Branch Purchase from Bank of America, N.A and acquired approximately $186.4 million in deposits. At December 31, 2016 approximately $162.2 million of the acquired deposits remained with the Bank. These branches attracted new deposits with an aggregated total of $195.5 million including public funds for the year ended December 31, 2016.

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The following table sets forth the dollar amount of savings deposits in the various types of deposit programs the Company offered at the dates indicated.

| | December 31, | | | |
|---|---|---|---|---|
| (Dollars in thousands) | 2016 | | 2015 | |
| Transactions and Savings Deposits | Amount | Percent of Total | Amount | Percent of Total |
| Noninterest-bearing checking | $143,236 | 20.10 % | $66,676 | 13.74 % |
| Interest-bearing checking | 66,119 | 9.28 | 34,098 | 7.03 |
| Savings | 54,995 | 7.71 | 30,126 | 6.21 |
| Money market | 242,849 | 34.08 | 159,605 | 32.89 |
| Escrow accounts related to mortgages serviced | 9,677 | 1.36 | 5,571 | 1.15 |
| Total transaction and savings deposits | 516,876 | 72.53 | 296,076 | 61.02 |
| Certificates | | | | |
| 0.00 - 1.99% | 192,665 | 27.04 | 188,586 | 38.87 |
| 2.00 - 3.99% | 2,973 | 0.42 | 516 | 0.11 |
| 8.00 | 79 | 0.01 | — | — |
| Total certificates | 195,717 | 27.47 | 189,102 | 38.98 |
| Total deposits | $712,593 | 100.00% | $485,178 | 100.00% |

The following table sets forth the rate and maturity information of time deposit certificates at December 31, 2016.

| | Rate | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | 0.00-1.99% | 2.00-3.99% | 8.00% | Total | Percent of Total |
| Certificate accounts maturing in quarter ending: | | | | | |
| March 31, 2017 | $16,065 | $1,566 | $— | $17,631 | 9.01 % |
| June 30, 2017 | 31,687 | 603 | 15 | $32,305 | 16.51 |
| September 30, 2017 | 13,750 | 128 | — | $13,878 | 7.09 |
| December 31, 2017 | 20,043 | — | — | $20,043 | 10.24 |
| March 31, 2018 | 23,570 | 7 | — | $23,577 | 12.05 |
| June 30, 2018 | 14,524 | — | — | $14,524 | 7.42 |
| September 30, 2018 | 5,568 | 455 | — | $6,023 | 3.08 |
| December 31, 2018 | 14,247 | — | 64 | $14,311 | 7.31 |
| March 31, 2019 | 8,825 | — | — | $8,825 | 4.51 |
| June 30, 2019 | 5,181 | — | — | $5,181 | 2.65 |
| September 30, 2019 | 4,651 | — | — | $4,651 | 2.37 |
| December 31, 2019 | 4,143 | 17 | — | $4,160 | 2.12 |
| Thereafter | 30,411 | 197 | — | $30,608 | 15.64 |
| Total | $192,665 | $2,973 | $79 | $195,717 | 100.00% |
| Percent of total | 98.44 % | 1.52 % | 0.04% | 100.00 % | |

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The following table indicates the amount of jumbo certificates of deposit by time remaining until maturity at December 31, 2016. Jumbo certificates of deposit are certificates in amounts of $100,000 or more.

| (In thousands) | Maturity 3 Months or Less | Over 3 to 6 Months | Over 6 to 12 Months | Over 12 Months | Total |
|---|---|---|---|---|---|
| Certificates of deposit of less than $100,000[1] | $10,511 | $13,240 | $17,043 | $52,997 | $93,791 |
| Certificates of deposit of $100,000 through $250,000 | 3,815 | 15,940 | 14,362 | 40,715 | 74,832 |
| Certificates of deposit of $250,000 and over | 3,305 | 3,125 | 2,516 | 18,148 | 27,094 |
| Total certificates of deposit | $17,631 | $32,305 | $33,921 | $111,860 | $195,717 |

(1) Includes $47.1 million of brokered deposits as of December 31, 2016.

The Federal Reserve requires the Bank to maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the Federal Reserve Bank of San Francisco (“Federal Reserve Bank”). Negotiable order of withdrawal (“NOW”) accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to the reserve requirements, as are any non-personal time deposits at a savings bank. As of December 31, 2016, the Bank’s deposit with the Federal Reserve Bank and vault cash exceeded the reserve requirements.

Debt. Although customer deposits are the primary source of funds for lending and investment activities, the Company uses various borrowings such as advances and warehouse lines of credit from the FHLB of Des Moines, and to a lesser extent Fed Funds purchased to supplement the supply of lendable funds, to meet short-term deposit withdrawal requirements and also to provide longer term funding to better match the duration of selected loan and investment maturities.

As one of the Company’s capital management strategies, the Company has used advances from the FHLB of Des Moines to fund loan originations in order to increase net interest income. Depending upon the retail banking activity, the Company will consider and may undertake additional leverage strategies within applicable regulatory requirements or restrictions. These borrowings would be expected to primarily consist of FHLB of Des Moines advances.

As a member of the FHLB of Des Moines, the Bank is required to own capital stock in the FHLB of Des Moines and authorized to apply for advances on the security of that stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the U.S. Government) provided certain creditworthiness standards have been met. Advances are individually made under various terms pursuant to several different credit programs, each with its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. The Bank maintains a committed credit facility with the FHLB of Des Moines that provides for immediately available advances up to an aggregate of $191.1 million. At December 31, 2016, outstanding advances from the FHLB of Des Moines totaled $12.7 million. At December 31, 2016, the Bank had $85.9 million additional short-term borrowing capacity with the Federal Reserve Bank. The Bank also had an aggregate of $40.0 million in unsecured Fed Funds lines of credit with other large financial institutions of which none was outstanding at December 31, 2016.

In addition, on October 15, 2015 (the “Closing Date”), FS Bancorp, Inc. closed on a third-party loan commitment by the issuance of an unsecured subordinated term note in the aggregate principal amount of $10.0 million due October 1, 2025 (the “Subordinated Note”). The Subordinated Note bears interest at an annual interest rate of 6.50%, payable by the Company quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, commencing on the first such date following the Closing Date and on the maturity date. The Subordinated Note will mature on October 1, 2025 but may be prepaid at the Company’s option and with regulatory approval at any time on or after five years after the Closing Date or at any time upon certain events, such as a change in the regulatory capital treatment of the

Subordinated Note or the interest on the Subordinated Note no longer being deductible by the Company for United States federal income tax purposes. The Company contributed $9.0 million of the proceeds from the Subordinated Note as additional capital to

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the Bank in the fourth quarter of 2015. See Note 9 of the Notes to Consolidated Financial Statements included in Item 8, “Financial Statements and Supplementary Data” of this Form 10-K.

The following tables set forth information regarding both long- and short-term borrowings.

| (Dollars in thousands) | Years Ended December 31, | | |
|---|---|---|---|
| Maximum balance: | 2016 | 2015 | 2014 |
| Federal Home Loan Bank advances and Fed Funds | $98,769 | $98,769 | $47,522 |
| Federal Reserve Bank | $1,000 | $— | $1,000 |
| Fed Funds lines of credit | $6,000 | $2,901 | $3,450 |
| Warehouse lines of credit | $— | $2,300 | $— |
| Subordinated note | $10,000 | $10,000 | $— |
| Average balances: | | | |
| Federal Home Loan Bank advances and Fed Funds | $26,259 | $38,393 | $22,589 |
| Federal Reserve Bank | $3 | $— | $33 |
| Fed Funds lines of credit | $16 | $145 | $72 |
| Warehouse lines of credit | $— | $1,886 | $— |
| Subordinated note | $10,000 | $2,120 | $— |
| Weighted average interest rate: | | | |
| Federal Home Loan Bank advances and Fed Funds | 0.98 % | 0.82 % | 1.23 % |
| Federal Reserve Bank | 1.00 % | — % | 0.75 % |
| Fed Funds lines of credit | 0.77 % | 0.42 % | 0.25 % |
| Warehouse lines of credit | — % | 4.18 % | — % |
| Subordinated note | 6.82 % | 6.79 % | — % |

| (Dollars in thousands) | At December 31, | | |
|---|---|---|---|
| Balance outstanding at end of year: | 2016 | 2015 | 2014 |
| Federal Home Loan Bank advances | $12,670 | $98,769 | $17,034 |
| Total borrowings | $12,670 | $98,769 | $17,034 |
| | | | |
| Weighted average interest rate of: | | | |
| Federal Home Loan Bank advances, at end of year | 1.24 % | 0.47 % | 1.35 % |

Subsidiary and Other Activities

The Company has one active subsidiary, the Bank, and the Bank has one inactive subsidiary. The Bank had no capital investment in its inactive subsidiary as of December 31, 2016.

Competition

The Company faces strong competition in attracting deposits. Competition in originating real estate loans comes primarily from other savings institutions, commercial banks, credit unions, life insurance companies and mortgage bankers. Other savings institutions, commercial banks, credit unions and finance companies provide vigorous competition in consumer lending, including indirect lending. Commercial business competition is primarily from local commercial banks. The Company competes by delivering high-quality, personal service to customers that result in a high level of customer satisfaction.

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The Company's market areas have a high concentration of financial institutions, many of which are branches of large money centers and regional banks that have resulted from the consolidation of the banking industry in Washington and other western states. These include such large national lenders as Wells Fargo, Bank of America, Chase and others in the Company's market area that have greater resources and offer services that the Bank does not provide. For example, the Bank does not offer trust services. Customers who seek "one-stop shopping" may be drawn to institutions that offer services that the Bank does not.

The Company attracts deposits through the branch office system. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds and other alternative investments. The Bank competes for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on the most recent branch deposit data provided by the FDIC, as of June 30, 2016, 1st Security Bank of Washington's share of aggregate deposits in the market area consisting of the four counties where the Company has branches was less than one percent.

Employees

At December 31, 2016, the Company had 306 full-time equivalent employees. Company employees are not represented by any collective bargaining group. The Company considers employee relations to be good.

Set forth below is certain information regarding the executive officers of the Company and the Bank. There are no family relationships among or between the executive officers.

Executive Officers. The following table sets forth information with respect to the executive officers of the Company and the Bank.

| | | Position | |
|---|---|---|---|
| Name | Age [(1)] | Company | Bank |
| Joseph C. Adams | 57 | Director and<br>Chief Executive Officer | Director and<br>Chief Executive Officer |
| Matthew D. Mullet | 38 | Chief Financial Officer, Treasurer and Secretary | Chief Financial Officer |
| Robert B. Fuller | 57 | Chief Credit Officer | Chief Credit Officer |
| Dennis V. O'Leary | 49 | — | Chief Lending Officer |
| Drew B. Ness | 52 | — | Chief Operating Officer |
| Donn C. Costa | 55 | — | Executive Vice President, Home Lending |
| Debbie L. Steck | 57 | — | Executive Vice President, Home Lending Operations |

(1) As of December 31, 2016.

Joseph C. Adams, age 57, is a director and has been the Chief Executive Officer of 1st Security Bank of Washington since July 2004. He joined 1st Security Bank of Washington in April 2003 as its Chief Financial Officer, when the Bank was Washington's Credit Union. Mr. Adams also served as Supervisory Committee Chairperson from 1993 to 1999. Mr. Adams is a lawyer having worked for Deloitte as a tax consultant, K&L Gates as a lawyer and then at Univar USA as a lawyer and Director, Regulatory Affairs. Mr. Adams received a Masters Degree equivalent from the

Pacific Coast Banking School. Mr. Adams' legal and accounting backgrounds, as well as his duties as Chief Executive Officer of 1st Security Bank of Washington, bring a special knowledge of the financial, economic and regulatory challenges faced by the Bank which makes him well suited to educate the Board on these matters.

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Matthew D. Mullet, age 38, joined 1st Security Bank of Washington in July 2011 and was appointed Chief Financial Officer in September 2011. Mr. Mullet started his banking career in June 2000 as a financial examiner with the Washington State Department of Financial Institutions, Division of Banks, where he worked until October 2004. From October 2004 until August 2010, Mr. Mullet was employed at Golf Savings Bank, Mountlake Terrace, WA, where he served in several financial capacities, including as Chief Financial Officer from May 2007 until August 2010. In August 2010, Golf Savings Bank was merged with Sterling Savings Bank, where Mr. Mullet held the position as Senior Vice President of the Home Loan Division until resigning and commencing work at 1st Security Bank of Washington.

Robert B. Fuller, age 57, joined 1st Security Bank of Washington as Chief Credit Officer in September of 2013. Prior to his employment with the Bank, Mr. Fuller served as Chief Financial Officer/Chief Credit Officer for Blueprint Capital, REIT in 2013, Chief Credit Officer for Core Business Bank during 2012, and Plaza Bank during 2011, and in credit administration at Golf Savings Bank/Sterling Bank during 2009 and 2010. Mr. Fuller also served as Executive Vice President, Chief Operating Officer, and Chief Financial Officer for Golf Savings Bank from March 2001 to September 2006 and was a member of the integration team for the Golf sale to Sterling Savings Bank. Mr. Fuller started his banking career at US Bank of Washington's mid-market production team and has over 30 years of banking experience.

Dennis V. O'Leary, age 49, joined 1st Security Bank of Washington as Senior Vice President - Consumer, Small Business and Construction Lending in August 2011 and currently holds the position of Chief Lending Officer. Prior to his employment with the Bank, Mr. O'Leary previously was employed by Sterling Savings Bank from July 2006 until August 2011 as Senior Vice President and Puget Sound Regional Director of the residential construction lending division. Sterling Savings Bank acquired Golf Savings Bank in 2006 where Mr. O'Leary had served as Executive Vice President, Commercial Real Estate Lending, having previously served in various senior lending positions at Golf Savings Bank since June 1985.

Drew B. Ness, age 52, joined 1st Security Bank of Washington as Chief Operating Officer in 2008. Mr. Ness has over 26 years of diverse banking experience, including retail branch sales and service, branch network and project management, and national customer service training. He served as Vice President and Manager of the Corporate Deposit Operations Department for Washington Federal, Seattle, Washington from February 2008 until August 2008, following its acquisition of First Mutual Bank. Mr. Ness served as Vice President and Administrative/Operations Manager of the Retail Banking Group at First Mutual Bank, Bellevue, Washington from 2004 through February 2008, and, prior to that, in various management positions for Bank of America in Seattle, Washington and Newport Beach, California.

Donn C. Costa, age 55, Executive Vice President, Home Lending, joined 1st Security Bank of Washington in October 2011 as Senior Vice President, Home Lending. He previously held the position of Executive Vice President at Sterling Savings Bank, Mountlake Terrace, Washington after the merger with Golf Savings Bank in August 2009, and held the position of Executive Vice President at Golf Savings Bank, Mountlake Terrace, Washington since 2006. With more than 25 years of home lending experience, Mr. Costa began as a loan officer at Lomas and Nettleton Mortgage Company in Mountlake Terrace in 1986.

Debbie L. Steck, age 57, Executive Vice President, Home Lending Operations, joined 1st Security Bank of Washington in September 2011. Prior to her employment at the Bank, she served as Chief Operating Officer and Vice President at Sterling Savings Bank after the merger with Golf Savings Bank in August 2009, and held that position with Golf Savings Bank for several years prior to that. Ms. Steck has over 30 years of experience in the mortgage industry. She currently serves on the Board of Directors for the Everett Gospel Mission.

HOW WE ARE REGULATED

The following is a brief description of certain laws and regulations applicable to FS Bancorp and 1st Security Bank of Washington. Descriptions of laws and regulations here and elsewhere in this Form 10-K do not purport to be complete and are qualified in their entirety by reference to the actual laws and regulations. Legislation is introduced from time to time in the United States Congress or in the Washington State Legislature that may affect the operations of FS Bancorp and 1st Security Bank of Washington. In addition, the regulations governing the Company and the Bank may be amended from time to time by the FDIC, DFI, Federal Reserve and the Consumer Financial Protection Bureau

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(“CFPB”). Any such legislation or regulatory changes in the future could adversely affect our operations and financial condition. We cannot predict whether any such changes may occur.

The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”). Among other changes, the Dodd-Frank Act established the CFPB as an independent bureau of the Federal Reserve Board. The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. However, institutions of less than $10 billion in assets, such as 1st Security Bank of Washington, subject to consumer protection regulations issued by the CFPB, but as a smaller financial institution, 1st Security Bank of Washington is generally subject to supervision and enforcement by the FDIC and the DFI with respect to its compliance with consumer financial protection laws and CFPB regulations.

Many aspects of the Dodd-Frank Act are subject to rulemaking by the federal banking agencies, which has not been completed and in some instances will not take effect for some time, making it difficult to anticipate the overall financial impact of the Dodd-Frank Act on 1st Security Bank of Washington, FS Bancorp and the financial services industry more generally.

Regulation of 1st Security Bank of Washington

General. 1st Security Bank of Washington, as a state-chartered savings bank, is subject to applicable provisions of Washington law and to regulations and examinations of the DFI. As an insured institution, it also is subject to examination and regulation by the FDIC, which insures the deposits of 1st Security Bank of Washington to the maximum permitted by law. During these state or federal regulatory examinations, the examiners may require 1st Security Bank of Washington to provide for higher general or specific loan loss reserves, which can impact capital and earnings. This regulation of 1st Security Bank of Washington is intended for the protection of depositors and the Deposit Insurance Fund (“DIF”) of the FDIC and not for the purpose of protecting shareholders of 1st Security Bank of Washington or FS Bancorp. 1st Security Bank of Washington is required to maintain minimum levels of regulatory capital and is subject to some limitations on the payment of dividends to FS Bancorp. See below “Regulatory Capital Requirements” and “Restrictions on Dividends and Stock Repurchases.”

Federal and State Enforcement Authority and Actions. As part of its supervisory authority over Washington-chartered savings banks, the DFI may initiate enforcement proceedings to obtain a consent order to cease-and-desist against an institution believed to have engaged in unsafe and unsound practices or to have violated a law, regulation, or other regulatory limit, including a written agreement. The FDIC also has the authority to initiate enforcement actions against insured institutions for similar reasons and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition. Both these agencies may utilize less formal supervisory tools to address their concerns about the condition, operations or compliance status of a savings bank.

Regulation by the Washington State Department of Financial Institutions. State law and regulations govern 1st Security Bank of Washington’s ability to take deposits and pay interest, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers, and to establish branch offices. As a state savings bank, 1st Security Bank of Washington must pay semi-annual assessments, examination costs and certain other charges to the DFI.

Washington law generally provides the same powers for Washington savings banks as federally and other-state chartered savings institutions and banks with branches in Washington, subject to the approval of the DFI. Washington law allows Washington savings banks to charge the maximum interest rates on loans and other extensions of credit to Washington residents which are allowable for a national bank in another state if higher than Washington limits. In addition, the DFI may approve applications by Washington savings banks to engage in an otherwise unauthorized activity, if the DFI determines that the activity is closely related to banking, and 1st Security Bank of Washington is otherwise qualified under the statute. This additional authority, however, is subject to review and approval by the FDIC if the activity is not permissible for national banks.

Insurance of Accounts and Regulation by the FDIC. The DIF of the FDIC insures deposit accounts in 1st Security Bank of Washington up to $250,000 per separately insured depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions.

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The Bank's deposit insurance premiums for the year ended December 31, 2016, were $487,000. Those premiums have been reduced in recent years due to management's focus on asset quality, risk management, and growing capital levels. The Dodd-Frank Act requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals 1.15%. Once the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the reserve ratio for the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

The FDIC conducts examinations of and requires reporting by state non-member banks, such as 1st Security Bank of Washington. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the DIF.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. These assessments, which may be revised based upon the level of DIF deposits, will continue until the bonds mature from 2017 through 2019. This payment is established quarterly and is an annual rate of 7.47 basis points of assessable assets for December 31, 2016. The Financing Corporation was chartered in 1987 solely for the purpose of functioning as a vehicle for the recapitalization of the deposit insurance system.

The FDIC may terminate the deposit insurance of any insured depository institution, including 1st Security Bank of Washington, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is aware of no existing circumstances which would result in termination of 1st Security Bank of Washington's deposit insurance.

A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of 1st Security Bank of Washington. There can be no prediction as to what changes in insurance assessment rates may be made in the future.

Prompt Corrective Action. Federal statutes establish a supervisory framework for FDIC-insured institutions based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The well capitalized category is described below in "Capital Requirements". An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by 1st Security Bank of Washington to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

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At December 31, 2016, 1st Security Bank of Washington was categorized as well capitalized under the prompt corrective action regulations of the FDIC. For additional information, see "Capital Requirements" below and Note 14 of the Notes to Consolidated Financial Statements included in Item 8, "Financial Statements and Supplementary Data," of this Form 10-K.

Capital Requirements. Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), 1st Security Bank of Washington became subject to new capital regulations adopted by the Federal Reserve and the FDIC, which created a new required ratio for common equity Tier 1 ("CET1") capital, increased the minimum leverage and Tier 1 capital ratios, changed the risk-weightings of certain assets for purposes of the risk-based capital ratios, created an additional capital conservation buffer over the required capital ratios, and changed what qualifies as capital for purposes of meeting the capital requirements. These regulations implement the regulatory capital reforms required by the Dodd Frank Act and the "Basel III" requirements.

Under the new capital regulations, t