TIMBERLAND BANCORP INC
Form 10-K
December 13, 2007

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

FORM 10-K

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

For the Fiscal Year Ended September 30, 2007

OR

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

Commission File Number: 0-23333

TIMBERLAND BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington	91-1863696
State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
624 Simpson Avenue, Hoquiam, Washington	98550
(Address of principal executive offices)	(Zip Code)
Registrant's telephone number, including area code:	(360) 533-4747

Securities registered pursuant to Section 12(b)of the Act:

Common Stock, par value $.01 per share	The Nasdaq Stock Market LLC
(Title of Each Class)	(Name of Each Exchange on Which Registered)

Securities registered pursuant to Section 12(g) of the Act: None

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 of 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 if 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 information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. X

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer ___ Accelerated filer X Non-accelerated filer ___

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

The aggregate market value of the Common Stock outstanding held by nonaffiliates of the Registrant based on the closing sales price of the Registrant's Common Stock as quoted on The Nasdaq Stock Market LLC on March 31, 2007 was $128,633,948 (7,298,380 shares at $17.625 per share). For purposes of this calculation, Common Stock held by officers and directors of the Registrant and the Timberland Bank Employee Stock Ownership Plan and Trust are considered nonaffiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Definitive Proxy Statement for the 2008 Annual Meeting of Stockholders (Part III).

TIMBERLAND BANCORP, INC.
2007 ANNUAL REPORT ON FORM 10-K
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PART I

Item 1. Business

General

Timberland Bancorp, Inc. ("Company"), a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB ("Bank") upon the Bank's conversion from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank ("Conversion"). The Conversion was completed on January 12, 1998 through the sale and issuance of 13,225,000 shares of common stock by the Company. At September 30, 2007, the Company had total assets of $644.8 million, total deposits of $466.7 million and total shareholders' equity of $74.5 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to the Bank and its subsidiary.

The Bank was established in 1915 as "Southwest Washington Savings and Loan Association." In 1935, the Bank converted from a state-chartered mutual savings and loan association to a federally chartered mutual savings and loan association, and in 1972, changed its name to "Timberland Federal Savings and Loan Association." In 1990, the Bank converted to a federally chartered mutual savings bank under the name "Timberland Savings Bank, FSB." In 1991, the Bank converted to a Washington-chartered mutual savings bank and changed its name to "Timberland Savings Bank, SSB." On December 29, 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation ("FDIC"). The Bank has been a member of the Federal Home Loan Bank ("FHLB") System since 1937. The Bank is regulated by the Washington Department of Financial Institutions, Division of Banks ("Division") and the FDIC.

The Bank is a community-oriented bank which has traditionally offered a variety of savings products to its retail customers while concentrating its lending activities on real estate mortgage loans. Lending activities have been focused primarily on the origination of loans secured by real estate, including an emphasis on construction and land development loans, one- to four-family residential loans, multi-family loans, commercial real estate loans and land loans. The Bank originates adjustable-rate residential mortgage loans that do not qualify for sale in the secondary market under Federal Home Loan Mortgage Corporation ("FHLMC") guidelines. The Bank also originates commercial business loans and in 1998 established a business banking division to increase the origination of these loans.

The Corporation maintains a website at www.timberlandbank.com. The information contained on that website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own internet access charges, the Corporation makes available free of charge through that website the Corporation's Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after these materials have been electronically filed with, or furnished to, the Securities and Exchange Commission.

Market Area

The Bank considers Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis Counties as its primary market areas. The Bank conducts operations from:

* its main office in Hoquiam (Grays Harbor County);

* five branch offices in Grays Harbor County (Ocean Shores, Montesano, Elma, and two branches in Aberdeen);

* a branch office in King County (Auburn);

* five branch offices in Pierce County (Edgewood, Puyallup, Spanaway, Tacoma, and Gig Harbor);

* five branch offices in Thurston County (Olympia, Yelm, Tumwater, and two branches in Lacey);

* two branch offices in Kitsap County (Poulsbo and Silverdale); and

* two branch offices and a loan production office in Lewis County (Winlock, Toledo and Centralia).

See "Item 2. Properties."

Hoquiam, with a population of approximately 9,000, is located in Grays Harbor County which is situated along Washington State's central Pacific coast. Hoquiam is located approximately 110 miles southwest of Seattle and 145 miles northwest of Portland, Oregon.

The Bank considers its primary market area to include six submarkets: primarily rural Grays Harbor County with its historical dependence on the timber and fishing industries; Pierce, Thurston and Kitsap Counties with their dependence on state and federal government; King County with its broadly diversified economic base; and Lewis County with its dependence on retail trade, manufacturing, industrial services and local government. Each of these markets presents operating risks to the Bank. The Bank's expansion into Pierce, Thurston, King, Kitsap and Lewis Counties represents the Bank's strategy to diversify its primary market area to become less reliant on the economy of Grays Harbor County.

Grays Harbor County has a population of 72,000 according to the U.S. Census Bureau 2006 estimates and a median family income of $49,900 according to 2007 HUD estimates. The economic base in Grays Harbor has been historically dependent on the timber and fishing industries. Other industries that support the economic base are tourism, agriculture, shipping, transportation and technology. According to the Washington State Employment Security Department, the unemployment rate in Grays Harbor County decreased to 6.2% at September 30, 2007 from 6.8% at September 30, 2006. The Bank has six branches (including its home office) located throughout the county. A slowdown in the Grays Harbor County economy could negatively impact the Bank's profitability in this market area.

Pierce County is the second most populous county in the state and has a population of 767,000 according to the U.S. Census Bureau 2006 estimates. The county's median family income is $61,500 according to 2007 HUD estimates. The economy in Pierce County is diversified with the presence of military related government employment (Fort Lewis Army Base and McChord Air Force Base), transportation and shipping employment (Port of Tacoma), and aerospace related employment (Boeing). According to the Washington State Employment Security Department, the unemployment rate for the Pierce County area decreased to 4.6% at September 30, 2007 from 5.4% at September 30, 2006. The Bank has five branches in Pierce County. These branches have been responsible for a substantial portion of the Bank's construction lending activities. A slowdown in the Pierce County economy could negatively impact the demand for construction loans and could negatively impact the Bank's profitability.

Thurston County has a population of 235,000 according to the U.S. Census Bureau 2006 estimates and a median family income of $64,300 according to 2007 HUD estimates. Thurston County is home of Washington State's capital (Olympia) and its economic base is largely driven by state government related employment. According to the Washington State Employment Security Department, the unemployment rate for the Thurston County area had decreased to 4.2% at September 30, 2007 from 4.8% at September 30, 2006. The Bank currently has five branches in Thurston County. This county has a stable economic base primarily attributable to the state government presence. A slowdown in the Thurston County economy could negatively impact the Bank's lending opportunities in this market.

Kitsap County has a population of 241,000 according to the U.S. Census Bureau 2006 estimates and a median family income of $65,700 according to 2007 HUD estimates. The Bank has two branches in Kitsap County. The economic base of Kitsap County is largely supported by military related government employment through the United States Navy. According to the Washington State Employment Security Department, the unemployment rate for the Kitsap County area decreased to 4.3% at September 30, 2007 from 5.2% at September 30, 2006. Reductions in the naval

personnel stationed in Kitsap County could have a negative impact on the county's economy and could negatively impact the Bank's lending opportunities in this market.

King County is the most populous county in the state and has a population of 1.8 million according to the U.S. Census Bureau 2006 estimates. The county's median family income is $75,600 according to 2007 HUD estimates. King County's economic base is diversified with many industries including shipping, transportation, aerospace (Boeing), computer technology and biotech industries. According to the Washington State Employment Security Department, the unemployment rate for the King County area decreased to 3.9% at September 30, 2007 from 4.1% at September 30, 2006. A slowdown in the King County economy could negatively impact the Bank's lending opportunities in this market.

Lewis County has a population of 74,000 according to the U.S. Census Bureau 2006 estimates and a median family income of $49,900 according to 2007 HUD estimates. The economic base in Lewis County is supported by manufacturing, retail trade, local government and industrial services. According to the Washington State Employment Security Department, the unemployment rate in Lewis County decreased to 6.3% at September 30, 2007 from 6.5% at September 30, 2006. The Bank has two branches and a loan production office located in Lewis County. A slowdown in the Lewis County economy could negatively impact the Bank's lending opportunities in this market.

Lending Activities

General. Historically, the principal lending activity of the Bank has consisted of the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences and loans for the construction of one- to four-family residences. Since 1998, the Bank has emphasized its origination of construction and land development loans and commercial real estate loans. The Bank's net loans receivable, including loans held for sale, totaled $515.3 million at September 30, 2007, representing 79.9% of consolidated total assets, and at that date construction and land development

loans (including undisbursed loans in process), and loans secured by commercial properties were $314.1 million, or 53.4%, of total loans. Construction and land development loans and commercial real estate loans typically have higher rates of return than one- to four-family loans; however, they also present a higher degree of risk. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Commercial Real Estate Lending."

The Bank's internal loan policy limits the maximum amount of loans to one borrower to 25% of its Tier 1 capital. At September 30, 2007, the maximum amount which the Bank could have lent to any one borrower and the borrower's related entities was approximately $14.8 million under this policy. At September 30, 2007, the largest amount outstanding to any one borrower and the borrower's related entities was $21.9 million (including $7.6 million in undisbursed loans in process balance). The Board of Directors approved this exception to the borrowing limit because of the strength of the primary borrower and the borrower's related entities. These loans represent a condominium construction project, several one- to four-family speculative construction projects, and commercial real estate holdings, all of which are located in Grays Harbor County. These loans were performing according to the required loan terms at September 30, 2007. The next largest amount outstanding to any one borrower and the borrower's related entities was $11.6 million. These loans were secured by three multi-family buildings and two one- to four-family homes, all of which were performing according to terms at September 30, 2007. The Bank also had 78 borrowers or related borrowers with total loans outstanding in excess of $1.0 million at September 30, 2007.

Loan Portfolio Analysis. The following table sets forth the composition of the Bank's loan portfolio by type of loan as of the dates indicated.

	At September 30,								
	2007		2006		2005		2004		
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amoun
	(Dollars in thousands)								
Mortgage Loans:									
One- to four-family(1)(2)..	$102,434	17.40%	$ 98,709	20.11%	$101,763	23.24%	$ 99,835	25.25%	$ 95,
Multi-family...	35,157	5.97	17,689	3.60	20,170	4.61	17,160	4.34	18,
Commercial.....	127,866	21.72	137,609	28.04	124,849	28.51	108,276	27.39	102,
Construction and land development...	186,261	31.64	146,855	29.92	112,470	25.68	106,241	26.88	94,
Land(2)........	60,706	10.30	29,598	6.03	24,981	5.71	19,895	5.03	15,
Total mortgage loans........	512,424	87.03	430,460	87.70	384,233	87.75	351,407	88.89	326,
Consumer Loans:									

Home equity and second mortgage......	47,269	8.02	37,435	7.63	32,298	7.38	23,549	5.96	19,
Other..........	10,922	1.86	11,127	2.27	9,330	2.13	9,270	2.34	8,
	58,191	9.88	48,562	9.90	41,628	9.51	32,819	8.30	28,
Commercial business loans..........	18,164	3.09	11,803	2.40	12,013	2.74	11,098	2.81	9,
Total loans...	588,779	100.00%	490,825	100.00%	437,874	100.00%	395,324	100.00%	363,
Less:									
Undisbursed portion of construction loans in process.......	(65,673)		(59,260)		(42,771)		(43,563)		(34,
Deferred loan origination fees..........	(2,968)		(2,798)		(2,895)		(3,176)		(2,
Allowance for loan losses...	(4,797)		(4,122)		(4,099)		(3,991)		(3,
Total loans receivable, net............	$515,341		$424,645		$388,109		$344,594		$322,

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(1) Includes loans held-for-sale.
(2) Includes real estate contracts. See " - Lending Activities - Real Estate Contracts."

Residential One- to Four-Family Lending. At September 30, 2007, $102.4 million, or 17.4%, of the Bank's loan portfolio consisted of loans secured by one- to four-family residences. The Bank originates both fixed-rate loans and adjustable-rate loans.

Generally, fixed-rate loans, including 15, 20, 30, and five and seven year balloon reset loans are originated to meet the requirements for sale in the secondary market to the FHLMC. From time to time, however, a portion of these fixed-rate loans may be retained in the loan portfolio to meet the Bank's asset/liability management objectives. The Bank periodically retains fixed-rate five and seven year balloon reset loans in its loan portfolio and classifies them as held-to-maturity. The Bank uses an automated underwriting program, which preliminarily qualifies a loan as conforming to FHLMC underwriting standards when the loan is originated. At September 30, 2007, $55.7 million, or 54.4%, of the Bank's one- to four-family loan portfolio consisted of fixed-rate mortgage loans.

The Bank also offers adjustable-rate mortgage ("ARM") loans at rates and terms competitive with market conditions. All of the Bank's ARM loans are retained in its loan portfolio rather than intended for sale. The Bank offers several ARM products which adjust annually after an initial period ranging from one to five years subject to a limitation on the annual increase of 2% and an overall limitation of 6%. These ARM products are priced utilizing the

weekly average yield on one year U.S. Treasury securities adjusted to a constant maturity of one year plus a margin of 2.875% to 4.00%. Loans tied to the prime rate or to LIBOR indices typically do not have periodic, or lifetime adjustment limits. Loans tied to these indices normally have margins ranging from 0.0% to 3.0%. ARM loans held in the Bank's portfolio do not permit negative amortization of principal. Borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. The relative amount of fixed-rate mortgage loans and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive

environment. At September 30, 2007, $46.7 million, or 45.6%, of the Bank's one- to four- family loan portfolio consisted of ARM loans.

A portion of the Bank's ARM loans are "non-conforming" because they do not satisfy acreage limits, or various other requirements imposed by the FHLMC. Some of these loans are also originated to meet the needs of borrowers who cannot otherwise satisfy the FHLMC credit requirements because of personal and financial reasons (i.e., divorce, bankruptcy, length of time employed, etc.), and other aspects, which do not conform to the FHLMC's guidelines. Many of these borrowers have higher debt-to-income ratios, or the loans are secured by unique properties in rural markets for which there are no sales of comparable properties to support value according to secondary market requirements. These loans are known as non-conforming loans and the Bank may require additional collateral or lower loan-to-value ratios to reduce the risk of these loans. The Bank believes that these loans satisfy a need in its local market area. As a result, subject to market conditions, the Bank intends to continue to originate these types of loans.

The retention of ARM loans in the Bank's loan portfolio helps reduce the Bank's exposure to changes in interest rates. There are, however, unquantifiable credit risks resulting from the potential of increased interest to be paid by the customer as a result of increases in interest rates. It is possible that during periods of rising interest rates the risk of default on ARM loans may increase as a result of repricing and the increased costs to the borrower. Furthermore, because the ARM loans originated by the Bank generally provide, as a marketing incentive, for initial rates of interest below the rates which would apply were the adjustment index used for pricing initially, these loans are subject to increased risks of default or delinquency. The Bank attempts to reduce the potential for delinquencies and defaults on ARM loans by qualifying the borrower based on the borrower's ability to repay the ARM loan assuming that the maximum interest rate that could be charged at the first adjustment period remains constant during the loan term. Another consideration is that although ARM loans allow the Bank to increase the sensitivity of its asset base due to changes in the interest rates, the extent of this interest sensitivity is limited by the periodic and lifetime interest rate adjustment limits. Because of these considerations, the Bank has no assurance that yield increases on ARM loans will be sufficient to offset increases in the Bank's cost of funds.

While fixed-rate, single-family residential mortgage loans are normally originated with 15 to 30 year terms, these loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full upon sale of the property pledged as security or upon refinancing the

original loan. In addition, substantially all mortgage loans in the Bank's loan portfolio contain due-on-sale clauses providing that the Bank may declare the unpaid amount due and payable upon the sale of the property securing the loan. Typically, the Bank enforces these due-on-sale clauses to the extent permitted by law and as business judgment dictates. Thus, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates received on outstanding loans.

The Bank requires that fire and extended coverage casualty insurance be maintained on all of its real estate secured loans. Loans originated since 1994 also require flood insurance, if appropriate.

The Bank's lending policies generally limit the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 95% of the lesser of the appraised value or the purchase price. However, the Bank usually obtains private mortgage insurance ("PMI") on the portion of the principal amount that exceeds 80% of the appraised value of the security property. The maximum loan-to-value ratio on mortgage loans secured by non-owner-occupied properties is generally 80% (90% for loans originated for sale in the secondary market to the FHLMC). At September 30, 2007 two single family loans totaling $252,000 were not performing according to their terms. See "- Lending Activities - Nonperforming Assets and Delinquencies."

Construction and Land Development Lending. Prompted by unfavorable economic conditions in its primary market area in the 1980s, the Bank sought to establish a market niche and, as a result, began originating construction loans outside of Grays Harbor County. In recent periods, construction lending activities have been primarily in the Pierce, King, Thurston, and Kitsap County markets. Competition from other financial institutions has increased in recent years and it is possible that margins on construction loans may be reduced in the future.

The Bank currently originates three types of residential construction loans: (i) speculative construction loans, (ii) custom construction loans and (iii) owner/builder construction loans. The Bank initiated its construction lending with the origination of speculative construction loans. As a result, the Bank began to establish contacts with the building community and increased the origination of custom construction and land development loans in rural and suburban market areas. The Bank believes that its computer tracking system has enabled it to establish processing and disbursement procedures to meet the needs of these borrowers. The Bank also originates construction loans for the development of multi-family and commercial properties. Subject to market conditions, the Bank intends to continue to emphasize its construction lending activities.

At September 30, 2007 and 2006, the composition of the Bank's construction and land development loan portfolio was as follows:

	At September 30,			
	2007		2006	
	Outstanding Balance	Percent of Total	Outstanding Balance	Percent of Total

	(In thousands)			
Speculative construction.....	$ 43,012	23.09%	$ 34,363	23.40%
Custom and owner/builder construction................	52,375	28.12	46,346	31.56
Multi-family.................	18,064	9.70	7,662	5.22
Land development.............	22,292	11.97	16,086	10.95
Commercial real estate.......	50,518	27.12	42,398	28.87
Total......................	$186,261	100.00%	$146,855	100.00%

Speculative construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of loan origination, a signed contract with a home buyer who has a commitment for permanent financing with either the Bank or another lender for the finished home. The home buyer may be identified either during or after the construction period, with the risk that the builder will have to debt service the speculative construction loan and finance real estate taxes and other carrying costs of the completed home for a significant time after the completion of construction until the home buyer is identified and a sale is consummated. The Bank lends to approximately 50 builders located in the Bank's primary market area, each of which generally have two to eight speculative loans outstanding from the Bank during a 12 month period. Rather than originating lines of credit to home builders to construct several homes at once, the Bank generally originates and underwrites a separate loan for each home. Speculative construction loans are generally originated for a term of 12 months, with current rates ranging from the prime rate to the prime rate plus 1.5%, and with a loan-to-value ratio of no more than 80% of the appraised estimated value of the completed property. During this 12 month period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance. At September 30, 2007, speculative construction loans totaled $43.0 million, or 23.1%, of the total construction loan portfolio. At September 30, 2007, the Bank had 21 borrowers each with aggregate outstanding speculative loan balances of more than $500,000. The largest aggregate outstanding balance to one borrower amounted to $7.2 million (including $4.7 million of undisbursed loans in process balance), and the largest outstanding balance for a single speculative loan was $1.2 million (including $363,000 of undisbursed loans in process balance). At September 30, 2007, one speculative construction loan with a balance of $1.0 million in Pierce County was not performing according to its terms. See "- Lending Activities - Nonperforming Assets and Delinquencies."

Unlike speculative construction loans, custom construction loans are made to home builders who, at the time of construction, have a signed contract with a home buyer who has a commitment to purchase the finished home. Custom construction loans are generally originated for a term of six to 12 months, with fixed interest rates currently ranging from 7.0% to 7.5% and with loan-to-value ratios of 80% of the appraised estimated value of the completed property or sales price, whichever is less. During the construction period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance.

Owner/builder construction loans are originated to the home owner rather than the home builder as a single loan that automatically converts to a permanent loan at the completion of construction. The construction phase of an owner/builder construction loan generally lasts up to 12 months with fixed

interest rates currently ranging from 7.0% to 7.5%, and with loan-to-value ratios of 80% (or up to 95% with PMI) of the appraised estimated value of the completed property. During the construction period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance. At the completion of construction, the loan converts automatically to either a fixed-rate mortgage loan, which conforms to secondary market standards, or an ARM loan for retention in the Bank's portfolio. At September 30, 2007, custom and owner/builder construction loans totaled $52.4 million, or 28.1%, of the total construction loan portfolio. At September 30, 2007, the largest outstanding custom and owner/builder construction loan had an outstanding balance of $1.0 million (including $552,000 of undisbursed loans in process balance) and was performing according to its terms.

The Bank originates loans to real estate developers with whom it has established relationships for the purpose of developing residential subdivisions (i.e., installing roads, sewers, water and other utilities) (generally with ten to 50 lots). At September 30, 2007, the Bank had 17 land development loans totaling $22.3 million, or 12.0% of construction and land development loans receivable. Land development loans are secured by a lien on the property and typically made for a period of two to five years with fixed or variable interest rates, and are made with loan-to-value ratios generally not exceeding 75%. Monthly interest payments are required during the term of the loan. Land development loans are generally structured so that the Bank is repaid in full upon the sale by the borrower of approximately 80% of the subdivision lots. Substantially all of the Bank's land development loans are secured by property located in its primary market area. In addition, in the case of a corporate borrower, the Bank also generally obtains personal guarantees from corporate principals and reviews their personal financial statements. At September 30, 2007, the largest land development loan had an outstanding loan balance of $3.9 million (including $1.9 million of undisbursed loans in process balance), and was performing according to its terms.

Land development loans secured by land under development involve greater risks than one- to four-family residential mortgage loans because these loans are advanced upon the predicted future value of the developed property upon completion. If the estimate of the future value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75% of the estimated developed value of the secured property.

The Bank also provides construction financing for multi-family and commercial properties. At September 30, 2007, these loans amounted to $68.6 million, or 36.8% of construction loans. These loans are secured by motels, apartment buildings, condominiums, mini-storage facilities, office buildings and retail rental space located in the Bank's primary market area and currently range in amount from $25,000 to $12.0 million. At September 30, 2007, the largest outstanding multi-family construction loan had a balance of $7.0 million (including $843,000 of undisbursed loans in process balance) and was performing according to its terms. At September 30, 2007, the largest outstanding commercial real estate construction loan had a balance of $12.0 million (including $9.9 million of undisbursed loans in process balance). This loan was secured by two mini-storage facilities being constructed in King County and was performing according to its terms.

All construction loans must be approved by a member of one of the Bank's Loan Committees or the Bank's Board of Directors. See "- Lending Activities - Loan Solicitation and Processing." Prior to preliminary approval of any construction loan application, an independent fee appraiser inspects the site and the Bank reviews the existing or proposed improvements, identifies the

market for the proposed project and analyzes the pro forma data and assumptions on the project. In the case of a speculative or custom construction loan, the Bank reviews the experience and expertise of the builder. After preliminary approval has been given, the application is processed, which includes obtaining credit reports, financial statements and tax returns on the borrowers and guarantors, an independent appraisal of the project, and any other expert reports necessary to evaluate the proposed project. In the event of cost overruns, the Bank generally requires that the borrower increase the funds available for construction by depositing its own funds into a secured savings account, the proceeds of which are used to pay construction costs.

Loan disbursements during the construction period are made to the builder, materials' supplier or subcontractor, based on a line item budget. Periodic on-site inspections are made by qualified inspectors to document the reasonableness of the draw request. For most builders, the Bank disburses loan funds by providing vouchers to suppliers, which when used by the builder to purchase supplies are submitted by the supplier to the Bank for payment.

The Bank regularly monitors the construction loan disbursements using an internal computer program. The Bank believes that its internal monitoring system helps reduce many of the risks inherent with construction lending.

The Bank originates construction loan applications primarily through customer referrals, contacts in the business community and occasionally real estate brokers seeking financing for their clients.

Construction lending affords the Bank the opportunity to achieve higher interest rates and fees with shorter terms to maturity than does its single-family permanent mortgage lending. Construction lending, however, is generally considered to involve a higher degree of risk than single-family permanent mortgage lending because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. If the estimate of construction cost proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, the Bank may be confronted with a project whose value is insufficient to assure full repayment and it may incur a loss. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the payoff for the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. The Bank has sought to address these risks by adhering to strict underwriting policies, disbursement procedures, and monitoring practices. In addition, because the Bank's construction lending is primarily secured by properties in its primary market area, changes in the local and state economies and real estate markets could adversely affect the Bank's construction loan portfolio.

Real Estate Contracts. The Bank purchases real estate contracts and deeds of trust from individuals who have privately sold their homes or property. These contracts are generally secured by one- to four-family properties, building lots and undeveloped land and range in principal amount from $10,000 to $200,000, but typically are in amounts between $20,000 and

$40,000. Properties securing real estate contracts purchased by the Bank are generally located within its primary market area. Prior to purchasing the real estate contract, the Bank reviews the contract and analyzes and assesses the collateral for the loan, the down payment made by the borrower and the credit history on the loan. As of September 30, 2007, the Bank had outstanding real estate contracts of $461,000.

Multi-Family Lending. At September 30, 2007, the Bank had $35.2 million, or 6.0% of the Bank's total loan portfolio, secured by multi-family dwelling units (more than four units) located primarily in the Bank's primary market area. Multi-family loans are generally originated with variable rates of interest ranging from 2.00% to 3.50% over the one-year constant maturity U.S. Treasury Bill Index or a matched term FHLB advance, with principal and interest payments fully amortizing over terms of up to 30 years. Multi-family loans currently range in principal balance from $40,000 to $5.8 million. At September 30, 2007, the largest multi-family loan had an outstanding principal balance of $5.8 million and was secured by an apartment building located in the Bank's primary market area. At September 30, 2007, this loan was performing according to its terms.

The maximum loan-to-value ratio for multi-family loans is generally 75% to 80%. The Bank generally requests its multi-family loan borrowers with loan balances in excess of $750,000 to submit financial statements and rent rolls on the subject property annually. The Bank also inspects the subject property annually. The Bank generally imposes a minimum debt coverage ratio of approximately 1.10 times for loans secured by multi-family properties.

Multi-family mortgage lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multi-family properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by multi-family properties are often

dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by strictly scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. If the borrower is other than an individual, the Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements.

Commercial Real Estate Lending. Commercial real estate loans totaled $127.9 million, or 21.7% of the total loan portfolio at September 30, 2007, and consisted of 298 loans. The Bank originated $35.9 million of commercial mortgage loans during the year ended September 30, 2007 compared to $32.2 million originated during the year ended September 30, 2006. The Bank originates commercial real estate loans generally at variable interest rates and these loans are secured by properties, such as restaurants, motels, office buildings and retail/wholesale facilities, located in the Bank's primary market area. The principal balances of commercial real estate loans currently ranges between $5,000 and $4.8 million. At September 30, 2007, the largest commercial real estate loan was secured by a commercial property located in Olympia, Washington, had a balance of $4.8 million and was performing

according to its terms. At September 30, 2007, one commercial real estate loan with a balance of $90,000 was not performing according to its terms. See "- Lending Activities - Nonperforming Assets and Delinquencies."

The Bank typically requires appraisals of properties securing commercial real estate loans. For loans that are less than $250,000, the Bank may use the tax assessed value and a property inspection in lieu of an appraisal. Appraisals are performed by independent appraisers designated by the Bank, all of which are reviewed by management. The Bank considers the quality and location of the real estate, the credit history of the borrower, the cash flow of the project and the quality of management involved with the property. The Bank generally imposes a minimum debt coverage ratio of approximately 1.10 for originated loans secured by income producing commercial properties. Loan-to-value ratios on commercial real estate loans are generally limited to not more than 80%. The Bank generally obtains loan guarantees from financially capable parties and reviews their personal financial statements.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by generally limiting the maximum loan-to-value ratio to 80% and strictly scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also requests annual financial information and rent rolls on the subject property from the borrowers on loans over $750,000.

Land Lending. The Bank originates loans for the acquisition of land upon which the purchaser can then build or make improvements necessary to build or to sell as improved lots. At September 30, 2007, land loans totaled $60.7 million, or 10.3% of the Bank's total loan portfolio as compared to $29.6 million, or 6.0% of the Bank's total loan portfolio at September 30, 2006. Land loans originated by the Bank are generally fixed-rate loans and have maturities of five to ten years. Land loans generally range in principal amount from $5,000 to $1.0 million but will occasionally be higher when larger acreage is involved. The largest land loan had an outstanding balance of $3.7 million at September 30, 2007 and was performing according to its terms. At September 30, 2007, one land loan totaling $28,000 was not performing according to its terms. See "- Lending Activities - Nonperforming Assets and Delinquencies."

Loans secured by undeveloped land or improved lots involve greater risks than one- to four-family residential mortgage loans because these loans are more difficult to evaluate. If the estimate of value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75%.

Consumer Lending. Consumer loans generally have shorter terms to maturity and higher interest rates than mortgage loans. Consumer loans include home equity lines of credit, second mortgage loans, savings account loans,

automobile loans, boat loans, motorcycle loans, recreational vehicle loans and unsecured loans. Consumer loans are made with both fixed and variable interest rates and with varying terms. At September 30, 2007, consumer loans amounted to $58.2 million, or 9.9%, of the total loan portfolio.

At September 30, 2007, the largest component of the consumer loan portfolio consisted of second mortgage loans and home equity lines of credit, which totaled $47.3 million, or 8.0%, of the total loan portfolio. Home equity lines of credit and second mortgage loans are made for purposes such as the improvement of residential properties, debt consolidation and education expenses, among others. The majority of these loans are made to existing customers and are secured by a first or second mortgage on residential property. The Bank occasionally solicits these loans. The loan-to-value ratio is typically 80% or less, when taking into account both the first and second mortgage loans. Second mortgage loans typically carry fixed interest rates with a fixed payment over a term between five and 15 years. Home equity lines of credit are generally made at interest rates tied to the prime rate or the 26 week Treasury Bill. Second mortgage loans and home equity lines of credit have greater credit risk than one- to four-family residential mortgage loans because they are secured by mortgages subordinated to the existing first mortgage on the property, which may or may not be held by the Bank.

Consumer loans entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. The Bank believes that these risks are not as prevalent in the case of the Bank's consumer loan portfolio because a large percentage of the portfolio consists of second mortgage loans and home equity lines of credit that are underwritten in a manner such that they result in credit risk that is substantially similar to one- to four-family residential mortgage loans. At September 30, 2007, the Bank did not have any consumer loans delinquent in excess of 90 days. See "Lending Activities - Non-performing Assets and Delinquencies."

Commercial Business Lending. Commercial business loans totaled $18.2 million, or 3.1% of the loan portfolio at September 30, 2007, and consisted of 60 loans. Commercial business loans are generally secured by business equipment, accounts receivable, inventory or other property and are made at variable rates of interest equal to a negotiated margin above the prime rate. Commercial business loans range in principal amount from $1,000 to $2.2 million. The Bank also generally obtains personal guarantees from financially capable applicants based on a review of personal financial statements. The largest commercial business loan had an outstanding balance of $2.2 million at September 30, 2007 and was performing according to its terms. At September 30, 2007, one commercial business loan with a balance of $120,000 was not performing according to its terms. See "Lending Activities-Nonperforming Assets and Delinquencies."

Commercial business lending generally involves greater risk than residential mortgage lending and involves risks that are different from those

associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral is viewed as the primary source of repayment in the event of borrower default. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors), while liquidation of collateral is a secondary and often insufficient source of repayment.

Loan Maturity. The following table sets forth certain information at September 30, 2007 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loans having no stated maturity and overdrafts are reported as due in one year or less.

	Within 1 Year	After 1 Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years	Total
			(In thousands)			
Mortgage loans:						
One- to four-family (1)	$ 747	$ 4,321	$ 3,069	$ 4,405	$ 89,892	$102,434
Multi-family	4,436	3,500	5,765	17,995	3,461	35,157
Commercial	5,441	9,390	13,199	85,507	14,329	127,866
Construction and land development(2)	177,601	8,570	90	--	--	186,261
Land	25,250	14,307	17,542	2,359	1,248	60,706
Consumer loans:						
Home equity and second mortgage	12,738	880	1,342	4,568	27,741	47,269
Other	1,876	915	2,090	1,288	4,753	10,922
Commercial business loans	9,267	1,094	4,142	1,489	2,172	18,164
Total	$237,356	$42,977	$47,239	$117,611	$143,596	$588,779
Less:						
Undisbursed portion of construction loans in process						$ 65,673
Deferred loan origination fees						2,968
Allowance for loan losses						4,797
Loans receivable, net						$515,341

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(1) Includes loans held-for-sale.
(2) Includes construction/permanent loans that convert to permanent mortgage loans once construction is completed.

The following table sets forth the dollar amount of all loans due after one year from September 30, 2007, which have fixed interest rates and have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates	Total
		(In thousands)	
Mortgage loans:			
One- to four-family(1)	$ 55,237	$ 46,450	$101,687
Multi-family	13,581	17,140	30,721
Commercial	17,379	105,046	122,425
Construction and land development	2,090	6,570	8,660
Land	25,395	10,061	35,456
Consumer loans:			
Home equity and second mortgage	26,620	7,911	34,531
Other	8,874	172	9,046
Commercial business loans	3,864	5,033	8,897
Total	$153,040	$198,383	$351,423

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(1) Includes loans held-for-sale.

Scheduled contractual principal repayments of loans do not reflect the actual life of these assets. The average life of loans is substantially less than their contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give the Bank the right to declare loans immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan interest rates are substantially higher than interest rates on existing mortgage loans and, conversely, decrease when interest rates on existing mortgage loans are substantially higher than current mortgage loan interest rates.

Loan Solicitation and Processing. Loan originations are obtained from a variety of sources, including walk-in customers, and referrals from builders and realtors. Upon receipt of a loan application from a prospective borrower, a credit report and other data are obtained to verify specific information relating to the loan applicant's employment, income and credit standing. An appraisal of the real estate offered as collateral generally is undertaken by an appraiser retained by the Bank and certified by the State of Washington.

Loan applications are initiated by loan officers and are required to be approved by one of the Bank's Loan Committees or the Bank's Board of Directors. The Bank's Consumer Loan Committee, which consists of three underwriters, can approve one-to four-family mortgage loans and other consumer loans up to and including the current FHLMC single-family limit. Certain consumer loans up to and including $25,000 may be approved by individual loan officers and the Bank's Consumer Lending Department Manager may approve

consumer loans up to and including $75,000. The Bank's Regional Manager of Commercial Lending has individual lending authority for loans up to and including $250,000, excluding speculative construction loans and unsecured loans. The Bank's Commercial Loan Committee, which consists of the Bank's President, Chief Lending Officer, Executive Vice President of Commercial Lending, Executive Vice President of Community Lending, and Regional Manager of Commercial Lending, may approve commercial real estate loans and commercial business loans up to and including $1.5 million. The Bank's President, Chief Lending Officer, Executive Vice President of Commercial Lending and Executive Vice President of Community Lending also have individual lending authority for loans up to and including $750,000. The Bank's Board Loan Committee, which consists of two rotating non-employee Directors and the Bank's President, may approve loans up to and including $3.0 million. Loans in excess of $3.0 million, as well as loans of any amount granted to a single borrower whose aggregate loans exceed $3.0 million, must be approved by the Bank's Board of Directors.

Loan Originations, Purchases and Sales. During the years ended September 30, 2007 and 2006, the Bank's total gross loan originations were $279.1 million and $256.3 million, respectively. Periodically, the Bank purchases participation interests in construction and land development loans, commercial real estate loans, and multi-family loans, secured by properties generally located in Washington State, from other lenders. These purchases are underwritten to the Bank's underwriting guidelines and are without recourse to the seller other than for fraud. During the years ended September 30, 2007 and 2006, the Bank purchased loan participation interests of $20.4 million and $155,000, respectively. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Multi-Family Lending."

Consistent with its asset/liability management strategy, the Bank's policy generally is to retain in its portfolio all ARM loans originated and to sell fixed rate one-to four-family mortgage loans in the secondary market to the FHLMC; however, from time to time, a portion of fixed-rate loans may be retained in the Bank's portfolio to meet its asset-liability objectives. Loans sold in the secondary market are generally sold on a servicing retained basis. At September 30, 2007, the Bank's loan servicing portfolio totaled $161.6 million.

The Bank also periodically sells participation interests in construction and land development loans, commercial real estate loans, and land loans to other lenders. These sales are usually made to avoid concentrations in a particular loan type or concentrations to a particular borrower. The Bank sold $6.7 million in loan participation interests to other lenders during the year ended September 30, 2007.

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

	Year Ended September 30,		
	2007	2006	2005
Loans originated:	(In thousands)		
Mortgage loans:			
One- to four-family.................	$ 33,252	$ 33,483	$ 33,290
Multi-family........................	4,397	3,037	4,685

Commercial	35,886	32,174	32,266
Construction and land development	127,082	129,623	104,714
Land	35,066	17,518	15,330
Consumer	32,354	29,858	29,287
Commercial business loans	11,020	10,559	10,233
Total loans originated	279,057	256,252	229,805
Loans purchased:			
Mortgage loans:			
One- to four-family	--	48	209
Multi-family	5,200	--	--
Commercial	--	79	--
Construction and land development	15,175	--	--
Land	--	28	--
Total loans purchased	20,375	155	209
Total loans originated and purchased	299,432	256,407	230,014
Loans sold:			
Whole loans sold	(29,893)	(26,445)	(25,247)
Participation loans sold	(6,650)	--	--
Credit card loans sold	--	--	(1,523)
Total loans sold	(36,543)	(26,445)	(26,770)
Loan principal repayments	(164,935)	(177,011)	(160,694)
Decrease (increase) in other items, net	(7,258)	(16,415)	965
Net increase in loans receivable	$ 90,696	$ 36,536	$ 43,515

Loan Origination Fees. The Bank receives loan origination fees on a majority of its mortgage loans and commercial business loans. Loan fees are a percentage of the loan which are charged to the borrower for funding the loan. The amount of fees charged by the Bank is generally 0.0% to 2.0% of the loan amount. Current accounting principles generally accepted in the United States of America require fees received and certain loan origination costs for originating loans to be deferred and amortized into interest income over the contractual life of the loan. Net deferred fees or costs associated with loans that are prepaid are recognized as income at the time of prepayment. Deferred loan origination fees totaled $3.0 million at September 30, 2007.

Non-performing Assets and Delinquencies. The Bank assesses late fees or penalty charges on delinquent loans of approximately 5% of the monthly loan payment amount. A majority of loan payments are due on the first day of the month; however, the borrower is given a 15 day grace period to make the loan payment. When a mortgage loan borrower fails to make a required payment when due, the Bank institutes collection procedures. A notice is mailed to the borrower 16 days after the date the payment is due. Attempts to contact the borrower by telephone generally begin on or before the 30th day of delinquency. If a satisfactory response is not obtained, continuous follow-up contacts are attempted until the loan has been brought current. Before the 90th day of delinquency, attempts are made to establish (i) the cause of the delinquency, (ii) whether the cause is temporary, (iii) the attitude of the borrower toward the debt, and (iv) a mutually satisfactory arrangement for curing the default.

If the borrower is chronically delinquent and all reasonable means of obtaining payment on time have been exhausted, foreclosure is initiated according to the terms of the security instrument and applicable law. Interest income on loans in foreclosure is reduced by the full amount of accrued and uncollected interest.

When a consumer loan borrower or commercial business borrower fails to make a required payment on a loan by the payment due date, the Bank institutes similar collection procedures as for its mortgage loan borrowers. Loans becoming 90 days or more past due are placed on non-accrual status, with any accrued interest reversed against interest income, unless they are well secured and in the process of collection.

The Bank's Board of Directors is informed monthly as to the status of loans that are delinquent by more than 30 days, the status of all loans currently in foreclosure, and the status of all foreclosed and repossessed property owned by the Bank.

The following table sets forth information with respect to the Company's nonperforming assets at the dates indicated.

	At September 30,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Loans accounted for on a non-accrual basis:					
Mortgage loans:					
One- to four-family.......	$ 252	$ 80	$ 2,208	$ 430	$ 1,409
Commercial...............	90	--	261	640	538
Construction and land development.............	1,000	--	--	--	1,185
Land......................	28	--	23	322	521
Consumer loans............	--	--	133	23	212
Commercial business loans..	120	--	301	27	30
Total..................	1,490	80	2,926	1,442	3,895
Accruing loans which are contractually past due 90 days or more.............	--	--	--	--	--
Total of non-accrual and 90 days past due loans.......	1,490	80	2,926	1,442	3,895
Other real estate owned and other repossessed assets..	--	15	509	421	1,258
Total nonperforming assets................	$ 1,490	$ 95	$ 3,435	$ 1,863	$ 5,153
Restructured loans.........	$ --	$ --	$ --	$ --	$ --
Non-accrual and 90 days or more past due loans					

as a percentage of loans receivable, net.....	0.29%	0.02%	0.75%	0.41%	1.19%
Non-accrual and 90 days or more past due loans as a percentage of total assets.............	0.23%	0.01%	0.53%	0.31%	0.87%
Nonperforming assets as a percentage of total assets...................	0.23%	0.02%	0.62%	0.40%	1.15%
Loans receivable, net(1)...	$520,138	$428,767	$392,208	$348,585	$326,127
Total assets..............	$644,848	$577,087	$552,765	$460,419	$449,633

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(1) Includes loans held-for-sale and is before the allowance for loan losses.

The Bank's non-accrual loans increased by $1.4 million to $1.5 million at September 30, 2007 from $80,000 at September 30, 2006, primarily as a result of a $1.0 million increase in construction and land development loans on non-accrual status, a $172,000 increase in one- to four-family mortgage loans on non-accrual status and a $90,000 increase in commercial real estate loans on non-accrual status.

Additional interest income which would have been recorded for the year ended September 30, 2007 had non-accruing loans been current in accordance with their original terms totaled approximately $42,000.

Other Real Estate Owned and Other Repossessed Items. Real estate acquired by the Bank as a result of foreclosure or by deed-in-lieu of foreclosure is classified as other real estate owned until sold. When 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 fair market value. Subsequent to foreclosure, the property is recorded at the lower of the foreclosed amount or fair value, less estimated selling costs. At September 30, 2007, the Bank did not have any other real estate owned or other repossessed items.

Restructured Loans. Under accounting principles generally accepted in the United States of America, the Bank is required to account for certain loan modifications or restructuring as a "troubled debt restructuring." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrowers that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower does not necessarily always constitute troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans. The Bank had no restructured loans at September 30, 2007.

Other Loans of Concern. Loans not reflected in the table above, but where known information about possible credit problems of borrowers causes management to have doubts as to the ability of the borrower to comply with present repayment terms and that may result in disclosure of such loans and

leases as underperforming assets in the future are commonly referred to as "potential problem loans." The amount included in potential problem loans results from an evaluation, on a loan-by-loan basis, of loans classified as "substandard" and "special mention," as those terms are defined under "Asset Classification" below. The amount of potential problem loans was $15.7 million at September 30, 2007 and $13.0 million at September 30, 2006. The vast majority of these loans, as well as our nonperforming assets, are collateralized.

Asset Classification. Applicable regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, regulatory examiners have authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. When an insured institution classifies problem assets as either substandard or doubtful, it is required to establish general allowances for loan losses in an amount deemed prudent by management. These allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities and the risks associated with particular problem assets. When an insured institution classifies problem assets as loss, it charges off the balance of the asset against the allowance for loan losses. Assets which do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated as special mention. The Bank's determination of the classification of its assets and the amount of its valuation allowances is subject to review by the FDIC and the Division which can order the establishment of additional loss allowances.

The aggregate amounts of the Bank's classified and special mention loans (as determined by the Bank), and of the Bank's allowances for loan losses at the dates indicated, were as follows:

	At September 30,		
	2007	2006	2005
	(In thousands)		
Loss	$ --	$ --	$ --
Doubtful	--	--	--
Substandard(1)	8,812	3,985	9,876
Special mention(1)	6,917	9,015	4,320
Total classified and special mention loans	$15,729	$13,000	$14,196

Allowance for loan losses.....	$ 4,797	$ 4,122	$ 4,099

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(1) For further information concerning the change in classified assets, see "- Lending Activities - Nonperforming Assets and Delinquencies."

The Bank's classified and special mention loans increased by $2.7 million from September 30, 2006 to September 30, 2007, primarily as a result of a $4.8 million increase in loans classified as substandard. This increase was partially offset by a $2.1 million decrease in loans classified as special mention.

Special mention loan are defined as those credits deemed by management to have some potential weakness that deserve management's close attention. If left uncorrected these potential weaknesses may result in the deterioration of the payment prospects of the loan. Assets in this category are not adversely classified and currently do not expose the Bank to sufficient risk to warrant a substandard classification. Three loans comprise a majority of the amount classified as special mention. They include a $3.4 million loan secured by a commercial office building in Thurston County, a $797,000 loan secured by land and commercial real estate in Grays Harbor County, and a $687,000 land development loan in Grays Harbor County. At September 30, 2007 these loans were current and paying in accordance with the required loan terms.

Substandard loans are classified as those loans that are inadequately protected by the current net worth, and paying capacity of the obligor, or of the collateral pledged. Assets classified as substandard have a well-defined weakness, or weaknesses that jeopardize the repayment of the debt. If the weakness, or weaknesses are not corrected there is the distinct possibility that some loss will be sustained. The aggregate amount of loans classified as substandard at September 30, 2007 increased by $4.8 million to $8.8 million from $4.0 million at September 30, 2006. At September 30, 2007, 26 loans were classified as substandard compared to 23 at September 30, 2006.

That largest loan currently classified as substandard is a $3.6 million commercial real state loan secured by a mini-storage facility in King County. This loan was classified as substandard as a result of slower than projected lease absorption of the storage units. At September 30, 2007, this loan was 54 days past due. The Bank also has a second loan with the borrowers secured by this mini-storage facility for $542,000. This loan was current at September 30, 2007 and was also classified as substandard. The Bank believes that these two loans are adequately collateralized.

The next largest loans classified as substandard include a $1.3 million commercial business loan secured by two mini-storage facilities in Pierce County and $1.3 million in loans to a construction company that were secured by two single family homes and a land parcel in Pierce County. The $1.3 million commercial business loan secured by the mini-storage facilities was current at September 30, 2007. The $1.3 million in loans to the construction company were on non-accrual status at September 30, 2007 and management estimated a $75,000 impairment on one of these loans that had a balance of $1.0 million.

Allowance for Loan Losses. The allowance for loan losses is maintained to cover estimated losses in the loan portfolio. The Bank has established a comprehensive methodology for the determination of provisions for loan losses

that takes into consideration the need for an overall general valuation allowance. The Bank's methodology for assessing the adequacy of its allowance for loan losses is based on its historic loss experience for various loan segments; adjusted or changes in economic conditions, delinquency rates, and other factors. Using these loss estimate factors, management develops a range of probable loss for each loan category. Certain individual loans for which full collectibility may not be assured are evaluated individually with loss exposure based on estimated discounted cash flows or collateral values. The total estimated range of loss based on these two components of the analysis is compared to the loan loss allowance balance. Based on this review, management will adjust the allowance as necessary to maintain directional consistency with trends in the loan portfolio.

In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. The Bank increases its allowance for loan losses by charging provisions for loan losses against the Bank's income.

The Board of Directors reviews the adequacy of the allowance for loan losses at least quarterly based on management's assessment of current economic conditions, past loss and collection experience, and risk characteristics of the loan portfolio.

At September 30, 2007, the Bank's allowance for loan losses totaled $4.8 million. This represents 0.92% of the total loans receivable and 321.95% of non-performing loans. The Bank's allowance for loan losses as a percentage of total loans receivable has decreased to 0.92% at September 30, 2007 from 1.19% at September 30, 2003 primarily due to improved historical loss performance (which has translated into lower loss factors assigned to certain loan categories), decreased levels of non-performing loans, and decreased levels of classified loans. Partially offsetting the improved credit quality ratios in recent years, has been a shift in the loan portfolio into a higher percentage of construction and land development loans, and land loans, which typically involve more risk than one- to four-family loans.

Management believes that the amount maintained in the allowance is adequate to absorb probable losses in the portfolio. Although management believes that it uses the best information available to make its determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be significantly and adversely affected if circumstances differ substantially from the assumptions used in making the determinations.

While the Bank believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses may adversely affect the Bank's financial condition and results of operations.

The following table sets forth an analysis of the Bank's allowance for loan losses for the periods indicated.

	Year Ended September 30,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
Allowance at beginning of year	$4,122	$4,099	$3,991	$3,891	$3,630
Provision for loan losses	686	--	141	167	347
Recoveries:					
Mortgage loans:					
One- to four-family	--	--	--	6	--
Consumer loans:					
Home equity and second mortgage	--	--	5	--	--
Other	1	5	3	16	12
Commercial business loans	--	20	9	3	70
Total recoveries	1	25	17	25	82
Charge-offs:					
Mortgage loans:					
One- to four-family	--	--	--	6	30
Multi-family	--	--	1	--	--
Commercial business loans	--	--	--	3	--
Land	--	--	1	--	10
Consumer loans:					
Home equity and second mortgage	--	--	--	9	40
Other	12	2	12	68	88
Commercial business loans	--	--	36	6	--
Total charge-offs	12	2	50	92	168
Net charge-offs (recoveries)	11	(23)	33	67	86
Balance at end of year	$4,797	$4,122	$4,099	$3,991	$3,891
Allowance for loan losses as a percentage of total loans receivable (net)(1) outstanding at the end of the year	0.92%	0.96%	1.05%	1.14%	1.19%
Net charge-offs (recoveries) as a percentage of average loans outstanding during the year	0.00%	(0.01%)	0.01%	0.02%	0.03%
Allowance for loan losses as a percentage of non-performing loans at end of year	321.95%	5,152.50%	140.09%	276.77%	99.90%

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(1) Total loans receivable (net) includes loans held for sale and is before the allowance for loan losses.

The following table sets forth the allocation of the allowance for loan losses by loan categ
dates indicated.

	At September 30,								
	2007		2006		2005		2004		
	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount
	(Dollars in thousands)								
Mortgage loans:									
One- to four-family........	$ 396	17.40%	$ 502	20.11%	$ 494	23.24%	$ 386	25.25%	$ 317
Multi-family..	200	5.97	112	3.60	194	4.61	242	4.34	374
Commercial....	1,368	21.72	1,222	28.04	1,544	28.51	1,443	27.39	1,041
Construction..	1,047	31.64	761	29.92	652	25.68	538	26.88	583
Land..........	549	10.30	275	6.03	255	5.71	226	5.03	169
Non-mortgage loans:									
Consumer loans........	412	9.88	497	9.90	255	9.51	427	8.30	458
Commercial business loans........	825	3.09	753	2.40	705	2.74	729	2.81	949
Total allowance for loan losses......	$4,797	100.00%	$4,122	100.00%	$4,099	100.00%	$3,991	100.00%	$3,891

Investment Activities

The investment policies of the Company are established and monitored by the Board of Directors. The policies are designed primarily to provide and maintain liquidity, to generate a favorable return on investments without incurring undue interest rate and credit risk, and to compliment the Bank's lending activities. These policies dictate the criteria for classifying securities as either available-for-sale or held-to-maturity. The policies permit investment in various types of liquid assets permissible under applicable regulations, which includes U.S. Treasury obligations, securities

of various federal agencies, certain certificates of deposit of insured banks, banker's acceptances, federal funds, mortgage-backed securities, and mutual funds. The Company's investment policy also permits investment in equity securities in certain financial service companies.

At September 30, 2007, the Company's investment portfolio totaled $64.0 million, primarily consisting of $31.9 million of mutual funds available-for-sale, $13.0 million of mortgage-backed securities available-for-sale, $19.0 million of U.S. agency securities available-for-sale, and $71,000 of securities held-to-maturity. This compares with a total investment portfolio of $81.5 million at September 30, 2006, primarily consisting of $32.1 million of mutual funds available-for-sale, $17.6 million of mortgage-backed securities available-for-sale, $31.7 million of U.S. agency securities available-for-sale, and $75,000 of securities held-to-maturity. The mutual funds invest primarily in mortgage-backed products and U.S. agency securities. The composition of the portfolios by type of security, at each respective date is presented in the table, which follows.

	At September 30,					
	2007		2006		2005	
	Recorded Value	Percent of Total	Recorded Value	Percent of Total	Recorded Value	Percent of Total
	(Dollars in thousands)					
Held-to-Maturity:						
Mortgage-backed securities.........	$ 71	0.11%	$ 75	0.09%	$ 104	0.12%
Available-for-Sale (at fair value):						
U.S. agency securities.........	18,976	29.66	31,718	38.93	33,695	37.56
Mortgage-backed securities.........	13,047	20.39	17,603	21.60	23,735	26.46
Mutual funds........	31,875	49.84	32,087	39.38	32,165	35.86
Total portfolio......	$63,969	100.00%	$81,483	100.00%	$89,699	100.00%

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The following table sets forth the maturities and weighted average yields of the investment and mortgage-backed securities in the Company's investment securities portfolio at September 30, 2007. Mutual funds, which by their nature do not have maturities, are classified in the less than one year category.

One Year or Less	After One to Five Years	After Five to Ten Years	After Year

	Amount	Yield	Amount	Yield	Amount	Yield	Amount
	(Dollars in thousands)						
Held-to-Maturity:							
Mortgage-backed securities............	$ --	--%	$ --	--%	$ --	--%	$ 71
Available-for-Sale:							
U.S. agency securities..	9,982	4.09	6,997	4.82	1,997	4.04	--
Mortgage-backed securities............	8	4.50	394	5.73	335	5.94	12,310
Mutual funds...........	31,875	5.33	--	--	--	--	--
Total portfolio.........	$41,865	5.04%	$7,391	4.87%	$2,332	4.31%	$12,381

The following table sets forth certain information with respect to each security which had an aggregate book value in excess of 10% of the Company's total equity at the date indicated.

	At September 30, 2007	
	Amortized Cost	Fair Value
	(In thousands)	
Asset Management Fund-Ultra Short Mortgage Fund (ASARX)..................................	$16,600	$16,078
Asset Management Fund-Ultra Short Fund (AULTX)....	10,000	9,719
Total..	$26,600	$25,797

Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major sources of the Bank's 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 money market conditions. Borrowings through the FHLB-Seattle and Pacific Coast Banker's Bank ("PCBB") may be used to compensate for reductions in the availability of funds from other sources.

Deposit Accounts. Substantially all of the Bank's depositors are residents of Washington. Deposits are attracted from within the Bank's market area through the offering of a broad selection of deposit instruments, including money market deposit accounts, checking accounts, regular savings accounts and certificates of deposit. 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 its deposit accounts, the Bank considers current market interest rates, profitability to the Bank, matching deposit and loan products and its customer

preferences and concerns. In recent periods, the Bank has used deposit interest rate promotions in connection with the opening of new branch offices. The Bank actively seeks consumer and commercial checking accounts through a checking account acquisition marketing program that was implemented in 2000. At September 30, 2007, the Bank had 29.0% of total deposits in non-interest bearing accounts and NOW checking accounts.

At September 30, 2007 the Bank had $67.3 million of jumbo certificates of deposit of $100,000 or more. The Bank also had brokered certificates of deposits totaling $24.1 million at September 30, 2007. The Bank believes that its jumbo certificates of deposit and its brokered deposits, which represented 19.6% of total deposits at September 30, 2007, present similar interest rate risk compared to its other deposits.

The following table sets forth information concerning the Bank's deposits at September 30, 2007.

Category	Weighted Average Interest Rate	Amount	Percentage of Total Deposits
		(In thousands)	
Non-interest bearing....................	--%	$ 54,962	11.77%
Negotiable order of withdrawal ("NOW") checking..............................	0.77	80,372	17.22
Savings................................	0.71	56,412	12.09
Money market...........................	2.58	48,068	10.30
Subtotal..............................	1.20	239,814	51.38
Certificates of Deposit(1)			
Maturing within 1 year..................	4.73	208,330	44.63
Maturing after 1 year but within 2 years................................	4.06	12,739	2.73
Maturing after 2 years but within 5 years................................	4.55	5,731	1.23
Maturing after 5 years..................	3.85	121	0.03
Total certificates of deposit..........	4.54	226,921	48.62
Total deposits........................	2.82%	$466,735	100.00%

(1) Based on remaining maturity of certificates.

The following table indicates the amount of the Bank's jumbo certificates of deposit by time remaining until maturity as of September 30, 2007. Jumbo certificates of deposit have principal balances of $100,000 or more and the rates paid on these accounts are generally negotiable.

Maturity Period	Amount
	(In thousands)

Three months or less............	$25,403
Over three through six months....	12,579
Over six through twelve months...	24,485
Over twelve months..............	4,849
Total..........................	$67,316

Deposit Flow. The following table sets forth the balances of deposits in the various types offered by the Bank at the dates indicated.

	At September 30,						
	2007			2006			2
	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	Increase (Decrease)	Amount
	(Dollars in thousands)						
Non-interest-bearing....	$ 54,962	11.77%	$ (2,943)	$ 57,905	13.43%	$ 6,114	$ 51,7
NOW checking...........	80,372	17.22	(9,137)	89,509	20.77	(3,969)	93,4
Savings................	56,412	12.09	(3,823)	60,235	13.97	(4,039)	64,2
Money market...........	48,068	10.30	5,690	42,378	9.83	(6,917)	49,2
Certificates of deposit which mature:							
Within 1 year.........	208,330	44.63	54,391	153,939	35.71	49,776	104,1
After 1 year, but within 2 years.......	12,739	2.73	(7,298)	20,037	4.65	(10,732)	30,7
After 2 years, but within 5 years.......	5,731	1.23	(1,279)	7,010	1.63	(10,735)	17,7
Certificates maturing thereafter..........	121	0.03	73	48	0.01	(102)	
Total..................	$466,735	100.00%	$35,674	$431,061	100.00%	$19,396	$411,

Certificates of Deposit by Rates. The following table sets forth the certificates of deposit in the Bank classified by rates as of the dates indicated.

At September 30,		
2007	2006	2005

	(In thousands)		
0.00 - 1.99%.........	$ 676	$ 2,176	$ 24,765
2.00 - 3.99%.........	46,810	69,736	125,541
4.00 - 5.99%.........	179,008	108,636	2,034
6.00% - and over.....	427	486	487
Total................	$226,921	$181,034	$152,827

Certificates of Deposit by Maturities. The following table sets forth the amount and maturities of certificates of deposit at September 30, 2007.

	Amount Due				
	Less Than One Year	One to Two Years	After Two to Five Years	After Five Years	Total
	(In thousands)				
0.00 - 1.99%............	$ 496	$ 144	$ 36	$ --	$ 676
2.00 - 3.99%............	36,370	7,956	2,363	121	46,810
4.00 - 5.99%............	171,408	4,630	2,970	--	179,008
6.00% and over..........	56	9	362	--	427
Total...................	$208,330	$12,739	$5,731	$121	$226,921

Deposit Activities. The following table sets forth the savings activities of the Bank for the periods indicated.

	Year Ended September 30,		
	2007	2006	2005
	(In thousands)		
Beginning balance.....................	$431,061	$411,665	$319,570
Net deposits before interest credited..	24,382	11,491	86,673
Interest credited.....................	11,292	7,905	5,422
Net increase in deposits..............	35,674	19,396	92,095
Ending balance........................	$466,735	$431,061	$411,665

Borrowings. Deposits are generally the primary source of funds for the Bank's lending and investment activities and for general business purposes. The Bank has the ability to use advances from the FHLB-Seattle to supplement its supply of lendable funds and to meet deposit withdrawal requirements. The FHLB-Seattle functions as a central reserve bank providing credit for member financial institutions. As a member of the FHLB-Seattle, the Bank is required to own capital stock in the FHLB-Seattle and is authorized to apply for advances on the security of such stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States government) provided certain creditworthiness standards have been met. Advances are made pursuant to several different credit programs. Each credit program has 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. At September 30, 2007, the Bank maintained an uncommitted credit facility with the FHLB-Seattle that provided for immediately available advances up to an aggregate amount of 30% of the Bank's total assets, limited by available collateral, under which $99.7 million was outstanding. The Bank also utilizes

overnight repurchase agreements with customers. These overnight repurchase agreements are classified as other borrowings and totaled $595,000 at September 30, 2007, $947,000 at September 30, 2006 and $781,000 at September 30, 2005. At September 30, 2007, the Bank also maintained a $10.0 million overnight borrowing line with PCBB under which there was no outstanding balance.

The following table sets forth certain information regarding borrowings by the Bank at the end of and during the periods indicated:

	At or For the Year Ended September 30,		
	2007	2006	2005
	(Dollars in thousands)		
Average total borrowings	$ 85,599	$55,773	$60,537
Weighted average rate paid on total borrowings	5.24%	5.22%	5.26%
Total borrowings outstanding at end of period	$100,292	$63,708	$63,134

The following table sets forth certain information regarding short-term borrowings by the Bank at the end of and during the periods indicated. Borrowings are considered short-term when the original maturity is less than one year.

	At or For the Year Ended September 30,		
	2007	2006	2005
	(Dollars in thousands)		
Maximum amount outstanding at any month end:			
FHLB advances	$72,750	$29,000	$ 9,000
Repurchase agreements	4,460	1,895	2,102
PCBB advances	--	--	--
Average outstanding during period:			
FHLB advances	$34,156	$ 3,516	$ 4,529
Repurchase agreements	1,019	1,148	1,345
PCBB advances	32	--	1
Total average outstanding during period	$35,207	$ 4,664	$ 5,875
Weighted average rate paid during period:			
FHLB advances	5.58%	4.81%	4.53%
Repurchase agreements	4.61	4.27	2.30

PCBB advances	6.45	--	4.80
Total weighted average rate paid during period	5.55%	4.67%	4.02%
Outstanding at end of period:			
FHLB advances	$30,000	$29,000	$ 8,000
Repurchase agreements	595	947	781
PCBB advances	--	--	--
Total outstanding at end of period	$30,595	$29,947	$ 8,781
Weighted average rate at end of period:			
FHLB advances	5.19%	5.49%	3.79%
Repurchase agreements	4.42	5.01	3.14
PCBB advances	--	--	--
Total weighted average rate at end of period	5.17%	5.47%	3.73%

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Bank Owned Life Insurance

The Bank has purchased life insurance policies covering certain officers. These policies are recorded at their cash surrender value, net of any policy premium charged. Increases in cash surrender value, net of policy premiums, and proceeds from death benefits are recorded in non-interest income. At September 30, 2007, the Bank had $12.4 million in bank owned life insurance.

REGULATION OF THE BANK

General

The Bank, as a state-chartered savings bank, is subject to regulation and oversight by the Division and the applicable provisions of Washington law and regulations of the Division adopted thereunder. The Bank also is subject to regulation and examination by the FDIC, which insures the deposits of the Bank to the maximum extent permitted by law, and requirements established by the Federal Reserve. State law and regulations govern the Bank's ability to take deposits and pay interest thereon, 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. Under state law, savings banks in Washington also generally have all of the powers that federal savings banks have under federal laws and regulations. The Bank is subject to periodic examination and reporting requirements by and of the Division.

Insurance of Accounts and Regulation by the FDIC

The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. The Deposit Insurance Fund is the successor to the Bank Insurance Fund and the Savings Association Insurance Fund, which were merged effective March 31, 2006. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious risk to the insurance fund. The FDIC also has the authority to initiate enforcement actions against savings institutions, after

giving the Office of Thrift Supervision an opportunity to take such action, and may terminate the deposit insurance if it determines that the institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The FDIC recently amended its risk-based assessment system for 2007 to implement authority granted by the Federal Deposit Insurance Reform Act of 2005, which was enacted in 2006 ("Reform Act"). Under the revised system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. An institution's assessment rate depends upon the category to which it is assigned. Risk category I, which contains the least risky depository institutions, is expected to include more than 90% of all institutions. Unlike the other categories, Risk Category I contains further risk differentiation based on the FDIC's analysis of financial ratios, examination component ratings and other information. Assessment rates are determined by the FDIC and currently range from five to seven basis points for the healthiest institutions (Risk Category I) to 43 basis points of assessable deposits for the riskiest (Risk Category IV). The FDIC may adjust rates uniformly from one quarter to the next, except that no single adjustment can exceed three basis points. No institution may pay a dividend if in default of the FDIC assessment.

The Reform Act also provided for a one-time credit for eligible institutions based on their assessment base as of December 31, 1996. Subject to certain limitations with respect to institutions that are exhibiting weaknesses, credits can be used to offset assessments until exhausted. The Bank's one-time credit is expected to be approximately $223,000. The Reform Act also provided for the possibility that the FDIC may pay dividends to insured institutions once the Deposit Insurance Fund reserve ratio equals or exceeds 1.35% of estimated insured deposits.

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. This payment is established quarterly and during the calendar year ended September 30, 2007 averaged 1.14 basis points of assessable deposits.

The Reform Act provided the FDIC with authority to adjust the Deposit Insurance Fund ratio to insured deposits within a range of 1.15% and 1.50%, in contrast to the prior statutorily fixed ratio of 1.25%. The ratio, which is viewed by the FDIC as the level that the fund should achieve, was established by the agency at 1.25% for 2007.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. There can be no prediction as to what insurance assessment rates will be in the future. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or the Office of Thrift Supervision. Management of the Bank is not aware of any practice, condition or violation that might lead to termination of the Bank's deposit insurance.

Prompt Corrective Action

The FDIC is required to take certain supervisory actions against undercapitalized savings institutions, the severity of which depends upon the institution's degree of undercapitalization. Generally, an institution that has a ratio of total capital to risk-weighted assets of less than 8%, a ratio of Tier I (core) capital to risk-weighted assets of less than 4%, or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be undercapitalized. An institution that has a total risk-based capital ratio less than 6%, a Tier I capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be significantly undercapitalized and an institution that has a tangible capital to assets ratio equal to or less than 2% is deemed to be critically undercapitalized. Subject to a narrow exception, the FDIC is required to appoint a receiver or conservator for a savings institution that is critically undercapitalized. FDIC regulations also require that a capital restoration plan be filed with the FDIC within 45 days of the date a savings institution receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Compliance with the plan must be guaranteed by any parent holding company in an amount of up to the lesser of 5% of the institution's assets or the amount which would bring the institution into compliance with all capital standards. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The FDIC also could take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At September 30, 2007, the Bank was categorized as "well capitalized" under the prompt corrective action regulations of the FDIC.

Standards for Safety and Soundness

The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to: internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the FDIC determines that the Bank fails to meet any standard prescribed by the guidelines, the agency may require the Bank to submit to the agency an acceptable plan to achieve compliance with the standard. FDIC regulations establish deadlines for the submission and review of such safety and soundness compliance plans. Management of the Bank is not aware of any conditions relating to these safety and soundness standards which would require submission of a plan of compliance.

Capital Requirements

FDIC regulations recognize two types or tiers of capital: core ("Tier 1") capital and supplementary ("Tier 2") capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and

limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred stock (original maturity of at least five years but less than 20 years) that may be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 4% to 5% of total assets. At September 30, 2007, the Bank had a Tier 1 leverage capital ratio of 9.5%. The FDIC retains the right to require an institution to maintain a higher capital level based on the institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of that category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect a bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At September 30, 2007, the Bank's ratio of total capital to risk-weighted assets was 12.1% and the ratio of Tier 1 capital to risk-weighted assets was 11.2%.

The Division requires that net worth equal at least 5% of total assets. Intangible assets must be deducted from net worth and assets when computing compliance with this requirement. At September 30, 2007, the Bank had a net worth of 9.3% of total assets.

The table below sets forth the Bank's capital position relative to its FDIC capital requirements at September 30, 2007. The definitions of the terms used in the table are those provided in the capital regulations issued by the FDIC, and the Bank has not been notified by the FDIC of any higher capital requirements specifically applicable to it.

	At September 30, 2007	
	Amount	Percent of Adjusted Total Assets (1)
	(Dollars in thousands)	
Tier 1 (leverage) capital (2)..............	$59,308	9.5%
Tier 1 (leverage) capital requirement......	25,058	4.0
Excess	$34,250	5.5%
Tier 1 risk adjusted capital..............	$59,308	11.2%
Tier 1 risk adjusted capital requirement...	21,154	4.0

Excess	$38,154	7.2%
	=======	====
Total risk-based capital..................	$64,105	12.1%
Total risk-based capital requirement.......	42,308	8.0
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Excess....................................	$21,797	4.1%
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(1) For the Tier 1 (leverage) capital and Washington regulatory capital calculations, percent of total average assets of $626.5 million. For the T