First Financial Northwest, Inc.
Form 10-Q
November 08, 2016

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

FORM 10-Q

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

For the quarterly period ended September 30, 2016

or

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

For the transition period from ____________ to ____________

Commission File Number: 001-33652

FIRST FINANCIAL NORTHWEST, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Washington<br>(State or other jurisdiction of incorporation or organization) | 26-0610707<br>(I.R.S. Employer Identification Number) |
| 201 Wells Avenue South, Renton, Washington<br>(Address of principal executive offices) | 98057<br>(Zip Code) |
| Registrant’s telephone number, including area code: | (425) 255-4400 |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES X NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES X NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer      Accelerated filer  X    Non-accelerated filer      Smaller reporting company ____

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES    NO  X

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 3, 2016, 10,931,431 shares of the issuer's common stock, $0.01 par value per share, were outstanding.

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FORM 10-Q
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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(Dollars in thousands, except share data)

Part 1. Financial Information

Item 1. Financial Statements

| Assets | September 30, 2016 (Unaudited) | December 31, 2015 |
|---|---|---|
| Cash on hand and in banks | $5,803 | $5,713 |
| Interest-earning deposits with banks | 26,708 | 99,998 |
| Investments available-for-sale, at fair value | 133,865 | 129,565 |
| Loans receivable, net of allowance of $11,006 and $9,463 | 845,930 | 685,072 |
| Federal Home Loan Bank ("FHLB") stock, at cost | 10,031 | 6,137 |
| Accrued interest receivable | 3,378 | 2,968 |
| Deferred tax assets, net | 3,053 | 4,556 |
| Other real estate owned ("OREO") | 2,331 | 3,663 |
| Premises and equipment, net | 18,296 | 17,707 |
| Bank owned life insurance ("BOLI"), net | 23,950 | 23,309 |
| Prepaid expenses and other assets | 1,353 | 1,225 |
| Total assets | $1,074,698 | $979,913 |
| | | |
| Liabilities and Stockholders' Equity | | |
| Deposits: | | |
| Noninterest-bearing deposits | $33,060 | $29,392 |
| Interest-bearing deposits | 659,111 | 646,015 |
| Total deposits | 692,171 | 675,407 |
| FHLB Advances | 221,500 | 125,500 |
| Advance payments from borrowers for taxes and insurance | 3,752 | 1,794 |
| Accrued interest payable | 116 | 135 |
| Other liabilities | 6,105 | 6,404 |
| Total liabilities | 923,644 | 809,240 |
| | | |
| Commitments and contingencies | | |
| Stockholders' Equity | | |
| Preferred stock, $0.01 par value; authorized 10,000,000 shares; no shares issued or outstanding | — | — |
| Common stock, $0.01 par value; authorized 90,000,000 shares; issued and outstanding 11,898,149 shares at September 30, 2016, and 13,768,814 shares at December 31, 2015 | 119 | 138 |
| Additional paid-in capital | 111,066 | 136,338 |
| Retained earnings, substantially restricted | 46,569 | 42,892 |
| Accumulated other comprehensive gain (loss), net of tax | 71 | (1,077) |
| Unearned Employee Stock Ownership Plan ("ESOP") shares | (6,771) | (7,618) |
| Total stockholders' equity | 151,054 | 170,673 |
| Total liabilities and stockholders' equity | $1,074,698 | $979,913 |

See accompanying selected notes to consolidated financial statements.

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Income Statements
(Dollars in thousands, except per share data)
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Interest income | | | | |
| Loans, including fees | $9,967 | $ 8,698 | $27,742 | $ 25,932 |
| Investments available-for-sale | 792 | 578 | 2,224 | 1,585 |
| Interest-earning deposits | 38 | 67 | 198 | 196 |
| Dividends on FHLB stock | 45 | 15 | 136 | 20 |
| Total interest income | 10,842 | 9,358 | 30,300 | 27,733 |
| Interest expense | | | | |
| Deposits | 1,545 | 1,369 | 4,469 | 4,016 |
| FHLB advances | 363 | 325 | 933 | 963 |
| Total interest expense | 1,908 | 1,694 | 5,402 | 4,979 |
| Net interest income | 8,934 | 7,664 | 24,898 | 22,754 |
| Provision (recapture of provision) for loan losses | 900 | (700) | 1,400 | (1,300) |
| Net interest income after provision (recapture of provision) for loan losses | 8,034 | 8,364 | 23,498 | 24,054 |
| Noninterest income | | | | |
| Net gain on sale of investments | 33 | 85 | 33 | 85 |
| BOLI income | 251 | 213 | 641 | 369 |
| Wealth management revenue | 165 | 41 | 656 | 64 |
| Other | 224 | 108 | 531 | 377 |
| Total noninterest income | 673 | 447 | 1,861 | 895 |
| Noninterest expense | | | | |
| Salaries and employee benefits | 3,821 | 3,488 | 11,436 | 10,153 |
| Occupancy and equipment | 467 | 387 | 1,463 | 1,039 |
| Professional fees | 458 | 472 | 1,487 | 1,284 |
| Data processing | 259 | 176 | 700 | 523 |
| Loss (Gain) on sale of OREO property, net | — | — | 87 | (531) |
| OREO market value adjustments | — | — | 257 | 5 |
| OREO related (reimbursements) expenses, net | (11) | 24 | (45) | 17 |
| Regulatory assessments | 82 | 119 | 319 | 351 |
| Insurance and bond premiums | 86 | 89 | 260 | 270 |
| Marketing | 67 | 103 | 145 | 190 |
| Other general and administrative | 25 | 523 | 990 | 1,244 |
| Total noninterest expense | 5,254 | 5,381 | 17,099 | 14,545 |
| Income before federal income tax provision | 3,453 | 3,430 | 8,260 | 10,404 |
| Federal income tax provision | 847 | 984 | 2,389 | 3,361 |
| Net income | $2,606 | $ 2,446 | $5,871 | $ 7,043 |
| Basic earnings per common share | $0.22 | $ 0.18 | $0.47 | $ 0.51 |
| Diluted earnings per common share | $0.22 | $ 0.18 | $0.47 | $ 0.51 |
| Basic weighted average number of common shares outstanding | 11,859,681 | 13,372,573 | 12,329,815 | 13,719,522 |
| Diluted weighted average number of common shares outstanding | 12,011,951 | 13,528,322 | 12,481,379 | 13,878,549 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income
(In thousands)
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net income | $2,606 | $2,446 | $5,871 | $7,043 |
| Other comprehensive income, before tax: | | | | |
| Gross unrealized holding (losses) gains on investments available-for-sale | (509) | 205 | 1,800 | (65) |
| Tax benefit (provision) | 178 | (72) | (631) | 22 |
| Reclassification adjustment for net gains realized in income | (33) | (85) | (33) | (85) |
| Tax provision | 12 | 30 | 12 | 30 |
| Other comprehensive (loss) income, net of tax | (352) | 78 | $1,148 | $(98) |
| Total comprehensive income | $2,254 | $2,524 | $7,019 | $6,945 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
(Dollars in thousands except share data)
(Unaudited)

| | Shares | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss), net of tax | Unearned ESOP Shares | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|
| Balances at December 31, 2014 | 15,167,381 | $ 151 | $ 153,395 | $ 36,969 | $ (357) | $ (8,746) | $ 181,412 |
| Other comprehensive income | — | — | — | 7,043 | (98) | — | 6,945 |
| Exercise of stock options | 100,000 | 1 | 690 | — | — | — | 691 |
| Compensation related to stock options and restricted stock awards | — | — | 330 | — | — | — | 330 |
| Allocation of 84,639 ESOP shares | — | — | 185 | — | — | 846 | 1,031 |
| Repurchase and retirement of common stock | (1,067,714) | (10) | (12,975) | — | — | — | (12,985) |
| Cash dividend declared and paid ($0.18 per share) | — | — | — | (2,469) | — | — | (2,469) |
| Balances at September 30, 2015 | 14,199,667 | $ 142 | $ 141,625 | $ 41,543 | $ (455) | $ (7,900) | $ 174,955 |

| | Shares | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss), net of tax | Unearned ESOP Shares | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|
| Balances at December 31, 2015 | 13,768,814 | $ 138 | $ 136,338 | $ 42,892 | $ (1,077) | $ (7,618) | $ 170,673 |
| Net income | | | | 5,871 | | | 5,871 |
| Other comprehensive income | — | — | — | — | 1,148 | — | 1,148 |
| Exercise of stock options | 63,173 | 1 | 317 | — | — | — | 318 |
| Issuance of common stock - restricted stock awards, net | 8,752 | — | (74) | — | — | — | (74) |
| Compensation related to stock options and restricted stock awards | — | — | 505 | — | — | — | 505 |
| Allocation of 84,639 ESOP shares | — | — | 298 | — | — | 847 | 1,145 |
| Repurchase and retirement of common stock | (1,868,112) | (19) | (26,319) | — | — | — | (26,338) |
| Canceled common stock - restricted stock awards | (74,478) | (1) | 1 | — | — | — | — |
| Cash dividend declared and paid ($0.18 per share) | — | — | — | (2,194) | — | — | (2,194) |
| Balances at September 30, 2016 | 11,898,149 | $ 119 | $ 111,066 | $ 46,569 | $ 71 | $ (6,771) | $ 151,054 |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | $5,871 | $7,043 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision (recapture of provision) for loan losses | 1,400 | (1,300) |
| OREO market value adjustments | 257 | 5 |
| Loss (gain) on sale of OREO property, net | 87 | (531) |
| Gain on sale of investments available-for-sale | (33) | (85) |
| Depreciation of premises and equipment | 797 | 570 |
| Amortization of premiums and discounts on investments available-for-sale, net | 726 | 852 |
| Deferred federal income taxes | 884 | 3,174 |
| Allocation of ESOP shares | 1,145 | 1,031 |
| Stock compensation expense | 505 | 330 |
| Change in cash surrender value of BOLI | (641) | (369) |
| Changes in operating assets and liabilities: | | |
| Prepaid expenses and other assets | (128) | 217 |
| Net increase in advance payments from borrowers for taxes and insurance | 1,958 | 1,232 |
| Accrued interest receivable | (410) | 193 |
| Accrued interest payable | (19) | — |
| Other liabilities | (299) | 1,357 |
| Net cash provided by operating activities | 12,100 | 13,719 |
| Cash flows from investing activities: | | |
| Proceeds from sales of OREO properties | 988 | 5,715 |
| Proceeds from calls and sales of investments available-for-sale | 24,921 | 23,771 |
| Principal repayments on investments available-for-sale | 12,375 | 14,463 |
| Purchases of investments available-for-sale | (40,522) | (44,674) |
| Net increase in loans receivable | (162,258) | (9,723) |
| (Redemption) purchase of FHLB stock | (3,894) | 208 |
| Purchases of premises and equipment | (1,386) | (1,351) |
| Surrender of BOLI | 10,182 | — |
| Purchase of BOLI | (10,182) | (20,000) |
| Net cash used by investing activities | (169,776) | (31,591) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 16,764 | 50,940 |
| Advances from the FHLB | 335,000 | — |
| Repayments of advances from the FHLB | (239,000) | — |
| Proceeds from stock options exercises | 318 | 691 |
| Net share settlement of stock awards | (74) | — |
| Repurchase and retirement of common stock | (26,338) | (12,985) |
| Dividends paid | (2,194) | (2,469) |
| Net cash provided by financing activities | 84,476 | 36,177 |

Continued

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Net (decrease) increase in cash and cash equivalents | $(73,200) | $18,305 |
| Cash and cash equivalents at beginning of period | 105,711 | 104,049 |
| Cash and cash equivalents at end of period | $32,511 | $122,354 |
| | | |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest paid | $5,421 | $4,979 |
| Federal income taxes paid | 2,025 | 177 |
| Noncash items: | | |
| Loans transferred to OREO, net of deferred loan fees and allowance for loan losses | $— | $141 |
| Change in unrealized loss on investments available for sale | 1,767 | (150) |

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

## Note 1 - Description of Business

First Financial Northwest, Inc. ("First Financial Northwest"), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Financial Northwest Bank ("the Bank") in connection with the conversion from a mutual holding company structure to a stock holding company structure completed on October 9, 2007. First Financial Northwest's business activities generally are limited to passive investment activities and oversight of its investment in First Financial Northwest Bank. Accordingly, the information presented in the consolidated financial statements and accompanying data, relates primarily to First Financial Northwest Bank. First Financial Northwest is a bank holding company, having converted from a savings and loan holding company on March 31, 2015, and as a bank holding company is subject to regulation by the Federal Reserve Bank of San Francisco. First Financial Northwest Bank is regulated by the Federal Deposit Insurance Corporation ("FDIC") and the Washington State Department of Financial Institutions ("DFI").

First Financial Northwest Bank is headquartered in Renton, Washington, where its main, full service retail branch is located. In addition, the Bank opened branches in Mill Creek, Washington in the third quarter of 2015, Edmonds, Washington in the first quarter of 2016, and The Landing in Renton, Washington in the third quarter of 2016. The Bank's primary market area consists of King, Snohomish, Pierce and Kitsap counties, Washington.

The Bank is a portfolio lender, originating one-to-four family residential, multifamily, commercial real estate, construction/land development, business, and consumer loans. Loans are primarily funded by deposits from the general public, supplemented by borrowings from the Federal Home Loan Bank of Des Moines ("FHLB") and deposits raised in the national brokered deposit market.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to First Financial Northwest, Inc. and its consolidated subsidiary First Financial Northwest Bank, unless the context otherwise requires.

## Note 2 - Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles ("GAAP") for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the unaudited interim consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the nine months ended September 30, 2016, are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the allowance for loan and lease losses ("ALLL"), the valuation of other real estate owned ("OREO") and the underlying collateral of impaired loans, deferred tax assets, and the fair value of financial instruments.

The Company's activities are considered to be a single industry segment for financial reporting purposes. The Company is engaged in the business of attracting deposits from the general public and originating and purchasing

loans for its portfolio. Substantially all income is derived from a diverse base of commercial, multifamily, and residential real estate loans, consumer lending activities, and investments.

Certain amounts in the unaudited interim consolidated financial statements for prior periods have been reclassified to conform to the current unaudited financial statement presentation with no effect on consolidated net income or stockholders' equity.



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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 3 - Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customer (Topic 606). In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606) which postponed the effective date of 2014-09. Subsequently, in March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations. This amendment clarifies that an entity should determine if it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. The core principle of Topic 606 is that an entity must recognize revenue when it has satisfied a performance obligation of transferring promised goods or services to a customer. The standard is effective for public entities for interim and annual periods beginning after December 15, 2017; early adoption is not permitted. The standard allows for full retrospective adoption for all periods presented or modified retrospective adoption to only the most current period presented in the financial statements. The cumulative effect of initially applying the standard is recognized at the date of the initial application. The Company is currently evaluating the provisions to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments--Overall, Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 requires equity investments (except those accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. The amendments in this ASU also require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in instrument-specific credit risk. In addition, the ASU eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. The ASU also clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early application is permitted for fiscal years or interim periods that have not yet been issued if adopted at the beginning of the fiscal year. The adoption of ASU 2016-01 is not expected to have a material impact on the Company's consolidated financial statements.

In February 2016, FASB issued ASU No. 2016-02, Leases (Topic 842). ASU No. 2016-02 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the amendments in the ASU is permitted. The adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements.
In March 2016, FASB issued ASU No. 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments. Topic 815 requires that embedded derivatives be separated from the host contract and accounted for separately as derivatives if certain criteria are met, including the “clearly and closely related” criterion. The amendments in this ASU clarify the requirements for assessing whether contingent call (put) options that can

accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the amendments is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. The amendments in this ASU apply to all entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. This ASU applies to all entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. The ASU is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Adoption of ASU 2016-06 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-09, Compensation--Stock Compensation (Topic 718). This ASU was issued as part of the FASB's Simplification Initiative and addresses accounting for share-based payment transactions, including income tax consequences and classification on the statement of cash flows. Under this ASU, all excess tax benefits and deficiencies should be recognized as income tax expense or benefit in the income statement. The tax effect of vested or exercised awards should be reported separately in the period in which they occur. In the statement of cash flows, excess tax benefits should be classified with



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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

other income tax cash flows as an operating activity. Entities have the option of accounting for forfeitures when they occur or to estimate the number of awards that are expected to vest. The amendments in this ASU are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted in any interim or annual period. First Financial Northwest has adopted ASU 2016-09 with no material impact on the Company's consolidated financial statements.

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

In August 2016, FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This ASU was to address the appropriate classification of eight specific cash flow issues on the cash flow statement. Debt prepayment costs should be classified as an outflow for financing activities. Settlement of zero-coupon debt instruments divides the interest portion as an outflow for operating activities and the principal portion as an outflow for financing activities. Contingent consideration payments made after a business combination should be classified as outflows for financing and operating activities. Proceeds from the settlement of bank-owned life insurance policies should be classified as inflows from investing activities. Other specific areas are identified in the ASU as to the appropriate classification of the cash inflows or outflows. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted and must be applied using a retrospective transition method to each period presented. Adoption of ASU 2016-15 is not expected to have a material impact on the Company's consolidated financial statements.

Note 4 - Investments

Investments available-for-sale are summarized as follows at the dates indicated:

| | September 30, 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In thousands) | | | |
| Mortgage-backed investments: | | | | |
| Fannie Mae | $41,456 | $ 719 | $ (31 ) | $42,144 |
| Freddie Mac | 18,969 | 489 | — | 19,458 |

| | | | | |
|---|---|---|---|---|
| Ginnie Mae | 20,006 | 114 | (153 ) | 19,967 |
| Municipal bonds | 13,237 | 584 | (4 ) | 13,817 |
| U.S. Government agencies | 14,296 | 174 | (5 ) | 14,465 |
| Corporate bonds | 24,007 | 404 | (397 ) | 24,014 |
| Total | $131,971 | $ 2,484 | $ (590 ) | $133,865 |

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In thousands) | | | |
| Mortgage-backed investments: | | | | |
| Fannie Mae | $50,288 | $ 260 | $ (227 ) | $50,321 |
| Freddie Mac | 26,011 | 243 | (117 ) | 26,137 |
| Ginnie Mae | 13,802 | 44 | (114 ) | 13,732 |
| Municipal bonds | 11,787 | 277 | — | 12,064 |
| U.S. Government agencies | 13,541 | 89 | (88 ) | 13,542 |
| Corporate bonds | 14,010 | 4 | (245 ) | 13,769 |
| Total | $129,439 | $ 917 | $ (791 ) | $129,565 |

The tables below summarize the aggregate fair value and gross unrealized loss by length of time those investment securities have been continuously in an unrealized loss position at the dates indicated. At September 30, 2016, we had two municipal bonds in an unrealized loss position. At December 31, 2015, we had no municipal bonds in an unrealized loss position.

| | September 30, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| | (In thousands) | | | | | |
| Mortgage-backed investments: | | | | | | |
| Fannie Mae | $9,194 | $ (31 ) | $— | $ — | $9,194 | $ (31 ) |
| Ginnie Mae | 15,877 | (153 ) | — | — | 15,877 | (153 ) |
| Municipal bonds | 447 | (4 ) | — | — | 447 | (4 ) |
| U.S. Government agencies | 2,002 | (2 ) | 1,617 | (3 ) | 3,619 | (5 ) |
| Corporate bonds | 3,883 | (117 ) | 4,720 | (280 ) | 8,603 | (397 ) |
| Total | $31,403 | $ (307 ) | $6,337 | $ (283 ) | $37,740 | $ (590 ) |

| | December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| | (In thousands) | | | | | |
| Mortgage-backed investments: | | | | | | |
| Fannie Mae | $37,593 | $ (227 ) | $— | $ — | $37,593 | $ (227 ) |
| Freddie Mac | 12,115 | (117 ) | — | — | 12,115 | (117 ) |
| Ginnie Mae | 5,508 | (29 ) | 3,233 | (85 ) | 8,741 | (114 ) |
| U.S. Government agencies | 9,605 | (88 ) | — | — | 9,605 | (88 ) |
| Corporate bonds | 10,263 | (245 ) | — | — | 10,263 | (245 ) |
| Total | $75,084 | $ (706 ) | $3,233 | $ (85 ) | $78,317 | $ (791 ) |

On a quarterly basis, management makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security on which there is an unrealized loss is impaired on an other-than-temporary basis. The Company considers many factors including the severity and duration of the impairment, recent events specific to the issuer or industry, and for debt securities, external credit ratings and recent downgrades. Securities on which there is an unrealized loss that is deemed to be an other-than-temporary impairment ("OTTI") are written down to fair value. If the Company intends to sell a debt security, or it is likely that the Company will be required to sell the debt security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the Company does not intend to sell the debt security and it is not likely that it will be required to sell the debt security but does not expect to recover the entire amortized cost basis of the debt

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security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a debt security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the debt security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ("OCI"). Impairment losses related to all other factors are presented as separate categories within OCI. At September 30, 2016 and December 31, 2015, the Company had 17 securities and 43 securities in an unrealized loss position, respectively, of which four and three, respectively, were in an unrealized loss position for 12 months or more. Management reviewed the financial condition of the entities issuing municipal or corporate bonds at September 30, 2016 and December 31, 2015, and determined that an OTTI charge was not warranted.

The amortized cost and estimated fair value of investments available-for-sale at September 30, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments, are shown separately.

| | September 30, 2016 | |
|---|---|---|
| | Amortized Cost | Fair Value |
| | (In thousands) | |
| Due within one year | $515 | $517 |
| Due after one year through five years | 8,861 | 8,919 |
| Due after five years through ten years | 25,518 | 25,804 |
| Due after ten years | 16,646 | 17,056 |
| | 51,540 | 52,296 |
| Mortgage-backed investments | 80,431 | 81,569 |
| Total | $131,971 | $133,865 |

Under Washington state law, in order to participate in the public funds program the Company is required to pledge eligible securities as collateral in an amount equal to 50% of the public deposits held. Investment securities with market values of $24.0 million and $17.4 million were pledged as collateral for public deposits at September 30, 2016 and December 31, 2015, respectively, both of which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission.

For the three and nine months ended September 30, 2016, we had calls and sales on investment securities of $24.5 million, and $24.9 million, respectively, generating a net gain of $33,000. For the three and nine months ended September 30, 2015, we had calls and sales of investment securities of $22.1 million and $23.7 million, respectively, generating a net gain of $85,000.

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Note 5 - Loans Receivable

Loans receivable are summarized as follows at the dates indicated:

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| | (In thousands) | |
| One-to-four family residential: | | |
| Permanent owner occupied | $148,304 | $ 147,229 |
| Permanent non-owner occupied | 107,601 | 106,543 |
| | 255,905 | 253,772 |
| Multifamily: | | |
| Permanent | 135,414 | 122,747 |
| Construction [1] | 49,325 | 21,115 |
| | 184,739 | 143,862 |
| Commercial real estate: | | |
| Permanent | 329,204 | 244,211 |
| Land [2] | 27,916 | 8,290 |
| | 357,120 | 252,501 |
| Construction/land development: | | |
| One-to-four family residential | 62,120 | 52,233 |
| Multifamily | 49,471 | 25,551 |
| Land development | 3,793 | 8,768 |
| | 115,384 | 86,552 |
| Business | 8,023 | 7,604 |
| Consumer | 6,526 | 6,979 |
| Total loans | 927,697 | 751,270 |
| Less: | | |
| Loans in process ("LIP") | 68,492 | 53,854 |
| Deferred loan fees, net | 2,269 | 2,881 |
| Allowance for loan and lease losses ("ALLL") | 11,006 | 9,463 |
| Loans receivable, net | $845,930 | $ 685,072 |

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[1] Construction/land development excludes construction loans that will convert to permanent loans. The Company considers these loans to be "rollovers" in that one loan is originated for both the construction loan and permanent financing. These loans are classified according to the underlying collateral.

[2] Includes raw land or buildable lots where the Company does not intend to finance the construction.

At September 30, 2016, loans totaling $434.6 million were pledged to secure borrowings from the FHLB of Des Moines compared to $365.1 million at December 31, 2015.

The Company has issued loans to officers and directors on the same terms as comparable loans to unrelated parties. The outstanding balance of these loans was $65,000 at September 30, 2016 and $118,000 at December 31, 2015.

ALLL. The Company maintains an ALLL as a reserve against probable and inherent risk of losses in its loan portfolios. The ALLL is comprised of a general reserve component for loans evaluated collectively for loss and a specific reserve component for loans evaluated individually. When an issue is identified and it is determined that the loan needs to be classified as nonperforming and/or impaired, an evaluation of the discounted expected cash flows is done and an appraisal may be obtained on the collateral.



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Based on this evaluation, additional provision for loan loss or charge-offs is recorded prior to the end of the financial reporting period.

The following tables summarize changes in the ALLL and loan portfolio by loan type and impairment method at the dates and for the periods shown:

| | At or For the Three Months Ended September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total |
| | (In thousands) | | | | | | |
| ALLL: | | | | | | | |
| Beginning balance | $2,747 | $ 1,421 | $ 4,021 | $ 1,403 | $ 217 | $ 325 | $10,134 |
| Charge-offs | — | — | — | — | — | (28) | (28) |
| Recoveries | — | — | — | — | — | — | — |
| Provision (recapture) | (60) | 130 | 641 | 178 | 25 | (14) | 900 |
| Ending balance | $2,687 | $ 1,551 | $ 4,662 | $ 1,581 | $ 242 | $ 283 | $11,006 |

| | At or For the Nine Months Ended September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total |
| | (In thousands) | | | | | | |
| ALLL: | | | | | | | |
| Beginning balance | $3,028 | $ 1,298 | $ 3,542 | $ 941 | $ 229 | $ 425 | $9,463 |
| Charge-offs | — | — | — | — | — | (47) | (47) |
| Recoveries | 85 | — | 104 | — | — | 1 | 190 |
| Provision (recapture) | (426) | 253 | 1,016 | 640 | 13 | (96) | 1,400 |
| Ending balance | $2,687 | $ 1,551 | $ 4,662 | $ 1,581 | $ 242 | $ 283 | $11,006 |
| ALLL by category: | | | | | | | |
| General reserve | $2,369 | $ 1,551 | $ 4,474 | $ 1,581 | $ 242 | $ 283 | $10,500 |
| Specific reserve | 318 | — | 188 | — | — | — | 506 |
| Loans: [1] | | | | | | | |
| Total loans | $255,905 | $ 159,083 | $ 357,120 | $ 72,545 | $ 8,023 | $ 6,530 | $859,206 |
| Loans collectively evaluated for impairment [2] | 227,650 | 157,511 | 352,203 | 72,545 | 8,023 | 6,400 | 824,332 |
| Loans individually evaluated for impairment [3] | 28,255 | 1,572 | 4,917 | — | — | 130 | 34,874 |

(1) Net of LIP.
(2) Loans collectively evaluated for general reserves.
(3) Loans individually evaluated for specific reserves.

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| | At or For the Three Months Ended September 30, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total |
| | (In thousands) | | | | | | |
| ALLL: | | | | | | | |
| Beginning balance | $3,536 | $ 1,187 | $ 4,436 | $ 819 | $ 189 | $ 436 | $10,603 |
| Charge-offs | (2 ) | — | — | — | — | (20 ) | (22 ) |
| Recoveries | 217 | — | 48 | — | — | — | 265 |
| Provision (recapture) | (245 ) | 15 | (579 ) | 76 | 21 | 12 | (700 ) |
| Ending balance | $3,506 | $ 1,202 | $ 3,905 | $ 895 | $ 210 | $ 428 | $10,146 |

| | At or For the Nine Months Ended September 30, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total |
| | (In thousands) | | | | | | |
| ALLL: | | | | | | | |
| Beginning balance | $3,694 | $ 1,646 | $ 4,597 | $ 355 | $ 47 | $ 152 | $10,491 |
| Charge-offs | (27 ) | (281 ) | — | — | — | (54 ) | (362 ) |
| Recoveries | 908 | — | 105 | — | 3 | 301 | 1,317 |
| Provision (recapture) | (1,069 ) | (163 ) | (797 ) | 540 | 160 | 29 | (1,300 ) |
| Ending balance | $3,506 | $ 1,202 | $ 3,905 | $ 895 | $ 210 | $ 428 | $10,146 |
| | | | | | | | |
| ALLL by category: | | | | | | | |
| General reserve | $2,945 | $ 1,199 | $ 3,665 | $ 895 | $ 210 | $ 388 | $9,302 |
| Specific reserve | 561 | 3 | 240 | — | — | 40 | 844 |
| | | | | | | | |
| Loans: [1] | | | | | | | |
| Total loans | 255,536 | 123,752 | 253,687 | 41,073 | 6,973 | 6,655 | 687,676 |
| Loans collectively evaluated for impairment [2] | 217,660 | 120,467 | 245,947 | 41,073 | 6,973 | 6,444 | 638,564 |
| Loans individually evaluated for impairment [3] | 37,876 | 3,285 | 7,740 | — | — | 211 | 49,112 |

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(1) Net of LIP.
(2) Loans collectively evaluated for general reserves.
(3) Loans individually evaluated for specific reserves.

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Past Due Loans. Loans are considered past due if a scheduled principal or interest payment is due and unpaid for 30 days or more. At September 30, 2016, total past due loans comprised 0.02% of total loans receivable, net of LIP, as compared to 0.18% at December 31, 2015. The following tables represent a summary of the aging of loans by type at the dates indicated:

| | Loans Past Due as of September 30, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | 30-59 Days | 60-89 Days | 90 Days and Greater | Total Past Due | Current | Total [1] [2] |
| | (In thousands) | | | | | |
| Real estate: | | | | | | |
| One-to-four family residential: | | | | | | |
| Owner occupied | $— | $ — | $ 169 | $169 | $148,135 | $148,304 |
| Non-owner occupied | — | — | — | — | 107,601 | 107,601 |
| Multifamily | — | — | — | — | 159,086 | 159,086 |
| Commercial real estate | — | — | — | — | 357,120 | 357,120 |
| Construction/land development | — | — | — | — | 72,546 | 72,546 |
| Total real estate | — | — | 169 | 169 | 844,488 | 844,657 |
| Business | — | — | — | — | 8,023 | 8,023 |
| Consumer | 12 | — | 25 | 37 | 6,489 | 6,526 |
| Total loans | $12 | $ — | $ 194 | $206 | $859,000 | $859,206 |

[1] There were no loans 90 days and greater past due and still accruing interest at September 30, 2016.
[2] Net of LIP.

| | Loans Past Due as of December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | 30-59 Days | 60-89 Days | 90 Days and Greater | Total Past Due | Current | Total [1] [2] |
| | (In thousands) | | | | | |
| Real estate: | | | | | | |
| One-to-four family residential: | | | | | | |
| Owner occupied | $678 | $483 | $ — | $1,161 | $146,068 | $147,229 |
| Non-owner occupied | — | — | — | — | 106,543 | 106,543 |
| Multifamily | — | — | — | — | 133,388 | 133,388 |
| Commercial real estate | — | — | — | — | 252,501 | 252,501 |
| Construction/land development | — | — | — | — | 43,172 | 43,172 |
| Total real estate | 678 | 483 | — | 1,161 | 681,672 | 682,833 |
| Business | — | — | — | — | 7,604 | 7,604 |
| Consumer | — | 78 | 19 | 97 | 6,882 | 6,979 |

| Total loans | $678 | $561 | $ 19 | $1,258 | $696,158 | $697,416 |
|---|---|---|---|---|---|---|

(1) There were no loans 90 days and greater past due and still accruing interest at December 31, 2015.
(2) Net of LIP.

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Nonaccrual Loans. The following table is a summary of nonaccrual loans by loan type at the dates indicated:

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| | (In thousands) | |
| One-to-four family residential | $986 | $ 996 |
| Consumer | 87 | 89 |
| Total nonaccrual loans | $1,073 | $ 1,085 |

During the three and nine months ended September 30, 2016, interest income that would have been recognized had these nonaccrual loans been performing in accordance with their original terms was $13,000 and $40,000, respectively. For the three and nine months ended September 30, 2015, foregone interest on nonaccrual loans was $31,000 and $87,000, respectively.

The following tables summarize the loan portfolio by type and payment status at the dates indicated:

| | September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction / Land Development | Business | Consumer | Total [1] |
| | (In thousands) | | | | | | |
| Performing [2] | $254,919 | $ 159,086 | $ 357,120 | $ 72,546 | $ 8,023 | $ 6,439 | $858,133 |
| Nonperforming [3] | 986 | — | — | — | — | 87 | 1,073 |
| Total loans | $255,905 | $ 159,086 | $ 357,120 | $ 72,546 | $ 8,023 | $ 6,526 | $859,206 |

[1] Net of LIP.
[2] There were $147.3 million of owner-occupied one-to-four family residential loans and $107.6 million of non-owner occupied one-to-four family residential loans classified as performing.
[3] There were $986,000 of owner-occupied one-to-four family residential loans and no non-owner occupied one-to-four family residential loans classified as nonperforming.

| | December 31, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total [1] |
| | (In thousands) | | | | | | |
| Performing [2] | $252,776 | $ 133,388 | $ 252,501 | $ 43,172 | $ 7,604 | $ 6,890 | $696,331 |
| Nonperforming [3] | 996 | — | — | — | — | 89 | 1,085 |
| Total loans | $253,772 | $ 133,388 | $ 252,501 | $ 43,172 | $ 7,604 | $ 6,979 | $697,416 |

[1] Net of LIP.

(2) There were $146.2 million of owner-occupied one-to-four family residential loans and $106.5 million of non-owner occupied one-to-four family residential loans classified as performing.
(3) There were $996,000 of owner-occupied one-to-four family residential loans and no non-owner occupied one-to-four family residential loans classified as nonperforming.

Impaired Loans. A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the original loan document. There were no funds committed to be advanced in connection with impaired loans at either September 30, 2016, or December 31, 2015.



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The following tables present a summary of loans individually evaluated for impairment by loan type at the dates indicated:

| | September 30, 2016 | | |
|---|---|---|---|
| | Recorded Investment (1) | Unpaid Principal Balance (2) | Related Allowance |
| | (In thousands) | | |
| Loans with no related allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | $2,414 | $2,738 | |
| Non-owner occupied | 19,179 | 19,197 | |
| Multifamily | 1,572 | 1,572 | |
| Commercial real estate | 1,347 | 1,425 | |
| Consumer | 130 | 212 | |
| Total | 24,642 | 25,144 | — |
| Loans with an allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 1,902 | 1,972 | 57 |
| Non-owner occupied | 4,760 | 4,781 | 261 |
| Commercial real estate | 3,570 | 3,570 | 188 |
| Total | 10,232 | 10,323 | 506 |
| Total impaired loans: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 4,316 | 4,710 | 57 |
| Non-owner occupied | 23,939 | 23,978 | 261 |
| Multifamily | 1,572 | 1,572 | — |
| Commercial real estate | 4,917 | 4,995 | 188 |
| Consumer | 130 | 212 | — |
| Total | $34,874 | $35,467 | $ 506 |

(1) Represents the loan balance less charge-offs.
(2) Contractual loan principal balance.

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| | December 31, 2015 | | |
|---|---|---|---|
| | Recorded Investment [1] | Unpaid Principal Balance [2] | Related Allowance |
| | (In thousands) | | |
| Loans with no related allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | $3,169 | $ 3,441 | $ — |
| Non-owner occupied | 23,285 | 23,310 | — |
| Multifamily | 415 | 414 | — |
| Commercial real estate | 2,675 | 2,857 | — |
| Consumer | 132 | 183 | — |
| Total | 29,676 | 30,205 | — |
| Loans with an allowance: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 2,120 | 2,189 | 85 |
| Non-owner occupied | 7,521 | 7,573 | 427 |
| Multifamily | 1,180 | 1,180 | 3 |
| Commercial real estate | 2,716 | 2,717 | 178 |
| Consumer | 76 | 76 | 39 |
| Total | 13,613 | 13,735 | 732 |
| Total impaired loans: | | | |
| One-to-four family residential: | | | |
| Owner occupied | 5,289 | 5,630 | 85 |
| Non-owner occupied | 30,806 | 30,883 | 427 |
| Multifamily | 1,595 | 1,594 | 3 |
| Commercial real estate | 5,391 | 5,574 | 178 |
| Consumer | 208 | 259 | 39 |
| Total | $43,289 | $ 43,940 | $ 732 |

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[1] Represents the loan balance less charge-offs.
[2] Contractual loan principal balance.

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

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2016 | |
|---|---|---|---|---|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| | (In thousands) | | | |
| Loans with no related allowance: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | $2,434 | $ 57 | $2,679 | $ 123 |
| Non-owner occupied | 20,208 | 296 | 21,234 | 878 |
| Multifamily | 1,576 | 26 | 1,189 | 79 |
| Commercial real estate | 1,796 | 31 | 2,089 | 77 |
| Consumer | 119 | 3 | 123 | 8 |
| Total | 26,133 | 413 | 27,314 | 1,165 |
| | | | | |
| Loans with an allowance: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | 2,003 | 28 | 2,042 | 78 |
| Non-owner occupied | 5,050 | 76 | 5,874 | 202 |
| Multifamily | — | — | 393 | — |
| Commercial real estate | 3,133 | 57 | 2,994 | 166 |
| Consumer | — | — | 25 | — |
| Total | 10,186 | 161 | 11,328 | 446 |
| | | | | |
| Total impaired loans: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | 4,437 | 85 | 4,721 | 201 |
| Non-owner occupied | 25,258 | 372 | 27,108 | 1,080 |
| Multifamily | 1,576 | 26 | 1,582 | 79 |
| Commercial real estate | 4,929 | 88 | 5,083 | 243 |
| Consumer | 119 | 3 | 148 | 8 |
| Total | $36,319 | $ 574 | $38,642 | $ 1,611 |

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| | Three Months Ended September 30, 2015 | | Nine Months Ended September 30, 2015 | |
|---|---|---|---|---|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| | (In thousands) | | | |
| Loans with no related allowance: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | $3,114 | $ 49 | $3,215 | $ 131 |
| Non-owner occupied | 25,142 | 361 | 26,835 | 1,123 |
| Multifamily | 2,101 | 8 | 1,471 | 23 |
| Commercial real estate | 4,757 | 85 | 4,650 | 269 |
| Consumer | 125 | 2 | 121 | 3 |
| Total | 35,239 | 505 | 36,292 | 1,549 |
| | | | | |
| Loans with an allowance: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | 2,131 | 12 | 2,240 | 89 |
| Non-owner occupied | 7,772 | 115 | 8,084 | 345 |
| Multifamily | 1,187 | 19 | 1,677 | 58 |
| Commercial real estate | 3,199 | 41 | 3,883 | 104 |
| Consumer | 77 | — | 78 | 2 |
| Total | 14,366 | 187 | 15,962 | 598 |
| | | | | |
| Total impaired loans: | | | | |
| One-to-four family residential: | | | | |
| Owner occupied | 5,245 | 61 | 5,455 | 220 |
| Non-owner occupied | 32,914 | 476 | 34,919 | 1,468 |
| Multifamily | 3,288 | 27 | 3,148 | 81 |
| Commercial real estate | 7,956 | 126 | 8,533 | 373 |
| Consumer | 202 | 2 | 199 | 5 |
| Total | $49,605 | $ 692 | $52,254 | $ 2,147 |

Troubled Debt Restructurings. Certain loan modifications are accounted for as troubled debt restructured loans ("TDRs"). At September 30, 2016, the TDR portfolio totaled $34.0 million, of which two loans totaling $182,000 were on nonaccrual status because they had previously not performed in accordance with the terms of their restructure. As of September 30, 2016, they were both current, however they will remain on nonaccrual status until they have performed for six months and are expected to continue to perform. At December 31, 2015, the TDR portfolio totaled $42.3 million, of which one loan of $131,000 was not performing in accordance with the terms of its restructure and was on nonaccrual status.

The following tables present loans that were modified as TDRs within the periods indicated and their recorded investment both before and after the modification:

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | Three Months Ended September 30, 2016 | | | Nine Months Ended September 30, 2016 | | |
|---|---|---|---|---|---|---|
| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| | (Dollars in thousands) | | | | | |
| One-to-four family residential: | | | | | | |
| Principal and interest with interest rate concession | 1 | $ 316 | $ 316 | 15 | $ 3,490 | $ 3,490 |
| Advancement of maturity date | 5 | 1,119 | 1,119 | 5 | 1,119 | 1,119 |
| Commercial real estate: | | | | | | |
| Interest-only payments with interest rate concession and advancement of maturity date | — | — | — | 1 | 495 | 495 |
| Advancement of maturity date | 1 | 434 | 434 | 1 | 434 | 434 |
| Total | 7 | $ 1,869 | $ 1,869 | 22 | $ 5,538 | $ 5,538 |

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | Three Months Ended September 30, 2015 | | | Nine Months Ended September 30, 2015 | | |
|---|---|---|---|---|---|---|
| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| | (Dollars in thousands) | | | | | |
| One-to-four family residential: | | | | | | |
| Interest-only payments with interest rate concession and advancement of maturity date | — | $ — | $ — | 6 | $ 1,439 | $ 1,439 |
| Principal and interest with interest rate concession and advancement of maturity date | 2 | $ 426 | $ 426 | 2 | $ 426 | $ 426 |
| Advancement of maturity date | — | — | — | 2 | 248 | 248 |
| Commercial real estate: | | | | | | |
| Principal and interest with interest rate concession and advancement of maturity date | 1 | 775 | 775 | 1 | 775 | 775 |
| Interest-only payments with interest rate concession and advancement of maturity date | — | — | — | 1 | 496 | 496 |
| Advancement of maturity date | — | — | — | 2 | 866 | 866 |
| Interest-only payments with advancement of maturity date | — | — | — | 1 | 2,004 | 2,004 |
| Total | 3 | $ 1,201 | $ 1,201 | 15 | $ 6,254 | $ 6,254 |

At September 30, 2016, the Company had no commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment as part of the calculation of the ALLL.

The TDRs that occurred during the three and nine months ended September 30, 2016 and 2015, included granting the borrower interest rate concessions and advancing the maturity date for a period of time ranging from one to three years. No loans accounted for as TDRs were charged-off to the ALLL for the three and nine months ended September 30, 2016 and 2015.

TDRs that default after they have been modified are typically evaluated individually on a collateral basis. Any additional impairment is charged to the ALLL. For the three months ended September 30, 2016 and the three and nine months ended September 30, 2015, no loans that had been modified in the previous 12 months defaulted. During the nine months ended September 30, 2016, one commercial loan of $495,000 that had been modified with an interest rate concession and advancement of maturity date within the previous 12 months missed one payment, but was current as of September 30, 2016.

Credit Quality Indicators. The Company utilizes a nine-category risk rating system and assigns a risk rating for all credit exposures. The risk rating system is designed to define the basic characteristics and identify risk elements of each credit extension. Credits risk rated 1 through 5 are considered to be “pass” credits. Pass credits include assets, such as cash secured loans with funds on deposit with the Bank, where there is virtually no credit risk. Pass credits also include credits that are on the Company's watch list, where the borrower exhibits potential weaknesses, which may, if not checked or corrected, negatively affect the borrower’s

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
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financial capacity and threaten their ability to fulfill debt obligations in the future. Credits classified as special mention are risk rated 6 and possess weaknesses that deserve management's close attention. Special mention assets do not expose the Company to sufficient risk to warrant adverse classification in the substandard, doubtful or loss categories. Substandard credits are risk rated 7. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged.

Substandard assets include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful are risk rated 8 and have all the weaknesses inherent in those credits classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions, and values. Assets classified as loss are risk rated 9 and are considered uncollectible and cannot be justified as a viable asset for the Company. There were no loans classified as doubtful or loss at September 30, 2016 and December 31, 2015.

The following tables represent a summary of loans by type and risk category at the dates indicated:

| | September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction/ Land Development | Business | Consumer | Total [1] |
| | (In thousands) | | | | | | |
| Risk Rating: | | | | | | | |
| Pass | $251,394 | $ 159,086 | $ 352,873 | $ 72,546 | $ 8,023 | $ 6,251 | $850,173 |
| Special mention | 2,971 | — | 3,752 | — | — | 188 | 6,911 |
| Substandard | 1,540 | — | 495 | — | — | 87 | 2,122 |
| Total loans | $255,905 | $ 159,086 | $ 357,120 | $ 72,546 | $ 8,023 | $ 6,526 | $859,206 |

(1) Net of LIP.

| | December 31, 2015 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-Four Family Residential | Multifamily | Commercial Real Estate | Construction / Land Development | Business | Consumer | Total [1] |
| | (In thousands) | | | | | | |
| Risk Rating: | | | | | | | |
| Pass | $247,239 | $ 133,388 | $ 248,196 | $ 43,172 | $ 7,604 | $ 6,702 | $686,301 |
| Special mention | 3,840 | — | 3,809 | — | — | 188 | 7,837 |
| Substandard | 2,693 | — | 496 | — | — | 89 | 3,278 |
| Total loans | $253,772 | $ 133,388 | $ 252,501 | $ 43,172 | $ 7,604 | $ 6,979 | $697,416 |

(1) Net of LIP.

Note 6 - Other Real Estate Owned

OREO includes properties acquired by the Company through foreclosure and deed in lieu of foreclosure. The following table is a summary of OREO activity during the periods shown:

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (In thousands) | | | |
| Balance at beginning of period | $2,331 | $4,416 | $3,663 | $9,283 |
| Loans transferred to OREO | — | — | — | 141 |
| Gross proceeds from sale of OREO | — | (181) | (988) | (5,715) |
| (Loss) gain on sale of OREO | — | — | (87) | 531 |
| Market value adjustments | — | — | (257) | (5) |
| Balance at end of period | $2,331 | $4,235 | $2,331 | $4,235 |

There were no sales of OREO properties during the three months ended September 30, 2016. During the nine months ended September 30, 2016, two OREO properties plus one parcel of a multi-parcel property with a combined book value of $1.1 million were sold, generating a net loss of $87,000. OREO at September 30, 2016 consisted of $2.3 million in commercial real estate properties.

Note 7 - Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The Company determines the fair values of its financial instruments based on the fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair values. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect its estimate for market assumptions.

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability using one of the three valuation techniques. Inputs can be observable or unobservable. Observable inputs are those assumptions that market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from an independent source. Unobservable inputs are assumptions based on the Company's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy:

- Level 1 - Quoted prices for identical instruments in active markets.

- Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable.

- Level 3 - Instruments whose significant value drivers are unobservable.

The tables below present the balances of assets measured at fair value on a recurring basis (there were no transfers between Level 1, Level 2 and Level 3 recurring measurements) at the dates indicated:

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | Fair Value Measurements at September 30, 2016 | | | |
|---|---|---|---|---|
| | Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (In thousands) | | | |
| Investments available-for-sale: | | | | |
| Mortgage-backed investments: | | | | |
| Fannie Mae | $42,144 | $ — | $ 42,144 | $ — |
| Freddie Mac | 19,458 | — | 19,458 | — |
| Ginnie Mae | 19,967 | — | 19,967 | — |
| Municipal bonds | 13,817 | — | 13,817 | — |
| U.S. Government agencies | 14,465 | — | 14,465 | — |
| Corporate bonds | 24,014 | — | 24,014 | — |
| Total | $133,865 | $ — | $ 133,865 | $ — |

| | Fair Value Measurements at December 31, 2015 | | | |
|---|---|---|---|---|
| | Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (In thousands) | | | |
| Investments available-for-sale: | | | | |
| Mortgage-backed investments: | | | | |
| Fannie Mae | $50,321 | $ — | $ 50,321 | $ — |
| Freddie Mac | 26,137 | — | 26,137 | — |
| Ginnie Mae | 13,732 | — | 13,732 | — |
| Municipal bonds | 12,064 | — | 12,064 | — |
| U.S. Government agencies | 13,542 | — | 13,542 | — |
| Corporate bonds | 13,769 | — | 13,769 | — |
| Total | $129,565 | $ — | $ 129,565 | $ — |

The estimated fair value of Level 2 investments is based on quoted prices for similar investments in active markets, identical or similar investments in markets that are not active and model-derived valuations whose inputs are observable.

The tables below present the balances of assets measured at fair value on a nonrecurring basis at September 30, 2016 and December 31, 2015.

| | Fair Value Measurements at September 30, 2016 | | | |
|---|---|---|---|---|
| | Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (In thousands) | | | |
| Impaired loans (included in loans receivable, net) [(1)] | $34,368 | $ — | $ — | $ 34,368 |
| OREO | 2,331 | — | — | 2,331 |
| Total | $36,699 | $ — | $ — | $ 36,699 |

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(1) Total fair value of impaired loans is net of $506,000 of specific reserves on performing TDRs.

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FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

| | Fair Value Measurements at December 31, 2015 | | | |
|---|---|---|---|---|
| | Fair Value Measurements | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | (In thousands) | | | |
| Impaired loans (included in loans receivable, net) [(1)] | $42,557 | $ — | $ — | $ 42,557 |
| OREO | 3,663 | — | — | 3,663 |
| Total | $46,220 | $ — | $ — | $ 46,220 |

______________

(1) Total fair value of impaired loans is net of $732,000 of specific reserves on performing TDRs.

The fair value of impaired loans is calculated using the collateral value method or on a discounted cash flow basis. Inputs used in the collateral value method include appraised values, less estimated costs to sell. Some of these inputs may not be observable in the marketplace. Appraised values may be discounted based on management's knowledge of the marketplace, subsequent changes in market conditions, or management's knowledge of the borrower.

OREO properties are measured at the lower of their carrying amount or fair value, less estimated costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at September 30, 2016 and December 31, 2015.

| | September 30, 2016 | | | |
|---|---|---|---|---|
| | Fair Value | Valuation Technique | Unobservable Input(s) | Range (Weighted Average) |
| | (Dollars in thousands) | | | |
| Impaired Loans | $34,368 | Market approach | Appraised value discounted by market or borrower conditions | 0 - 7.8% (0.1%) |
| OREO | $2,331 | Market approach | Appraised value less selling costs | 0.0% (0.0%) |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Fair Value | Valuation Technique | Unobservable Input(s) | Range (Weighted Average) |
| | (Dollars in thousands) | | | |
| Impaired Loans | $42,557 | Market approach | Appraised value discounted by market or borrower conditions | 0% - 2.1% (0.3%) |

| | | | | |
|---|---|---|---|---|
| OREO | $3,663 | Market approach | Appraised value less selling costs | 0% - 13.6% (1.0%) |

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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The carrying amounts and estimated fair values of financial instruments were as follows at the dates indicated:

| | September 30, 2016 | | | | |
|---|---|---|---|---|---|
| | | Estimated | Fair Value Measurements Using: | | |
| | Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
| | (In thousands) | | | | |
| Financial Assets: | | | | | |
| Cash on hand and in banks | $5,803 | $ 5,803 | $ 5,803 | $ — | $ — |
| Interest-earning deposits | 26,708 | 26,708 | 26,708 | — | — |
| Investments available-for-sale | 133,865 | 133,865 | — | 133,865 | — |
| Loans receivable, net | 845,930 | 862,708 | — | — | 862,708 |
| FHLB stock | 10,031 | 10,031 | — | 10,031 | — |
| Accrued interest receivable | 3,378 | 3,378 | — | 3,378 | — |
| Financial Liabilities: | | | | | |
| Deposits | 266,161 | 266,161 | 266,161 | — | — |
| Certificates of deposit, retail | 350,522 | 353,130 | — | 353,130 | — |
| Certificates of deposit, brokered | 75,488 | 75,599 | — | 75,599 | — |
| Advances from the FHLB | 221,500 | 221,788 | — | 221,788 | — |
| Accrued interest payable | 116 | 116 | — | 116 | — |

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | | Estimated | Fair Value Measurements Using: | | |
| | Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
| | (In thousands) | | | | |
| Financial Assets: | | | | | |
| Cash on hand and in banks | $5,713 | $ 5,713 | $ 5,713 | $ — | $ — |
| Interest-earning deposits | 99,998 | 99,998 | 99,998 | — | — |
| Investments available-for-sale | 129,565 | 129,565 | — | 129,565 | — |
| Loans receivable, net | 685,072 | 693,480 | — | — | 693,480 |
| FHLB stock | 6,137 | 6,137 | — | 6,137 | — |
| Accrued interest receivable | 2,968 | 2,968 | — | 2,968 | — |
| Financial Liabilities: | | | | | |
| Deposits | 285,416 | 285,416 | 285,416 | — | — |
| Certificates of deposit, retail | 323,840 | 324,135 | — | 324,135 | — |
| Certificates of deposit, brokered | 66,151 | 66,947 | — | 66,947 | — |
| Advances from the FHLB | 125,500 | 125,466 | — | 125,466 | — |
| Accrued interest payable | 135 | 135 | — | 135 | — |

Fair value estimates, methods, and assumptions are set forth below for the Company's financial instruments:

•

Financial instruments with book value equal to fair value: The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value. These instruments include cash on hand and in banks, interest-earning deposits, FHLB stock, accrued interest receivable, accrued interest payable, and investment transactions payable. FHLB stock is not publicly-traded, however it may be

redeemed on a dollar-for-dollar basis, for any amount the Bank is not required to hold, subject to the FHLB's discretion. The fair value is therefore equal to the book value.

- Investments available-for-sale: The fair value of all investments, excluding FHLB stock, was based upon quoted market prices for similar investments in active markets, identical or similar investments in markets that are not active and model-derived valuations whose inputs are observable.

- Loans receivable: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans is estimated using discounted cash flow analysis, utilizing interest rates that would be offered for loans with similar terms to borrowers of similar credit quality. As a result of current market conditions, cash flow estimates have been further discounted to include a credit factor. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

- Liabilities: The fair value of deposits with no stated maturity, such as statement savings, NOW and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows using current interest rates for certificates of deposit with similar remaining maturities. The fair value of FHLB advances is estimated based on discounting the future cash flows using current interest rates for debt with similar remaining maturities.

- Off balance sheet commitments: No fair value adjustment is necessary for commitments made to extend credit, which represents commitments for loan originations or for outstanding commitments to purchase loans. These commitments are at variable rates, are for loans with terms of less than one year and have interest rates which approximate prevailing market rates, or are set at the time of loan closing.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that are not considered financial instruments.

## Note 8 - Stock-Based Compensation

In June 2016, First Financial Northwest's shareholders approved the First Financial Northwest, Inc. 2016 Equity Incentive Plan ("2016 Plan"). This plan provides for the granting of incentive stock options ("ISO"), non-qualified stock options ("NQSO"), restricted stock and restricted stock units until June 2026. The 2016 Plan established 1,400,000 shares available to grant with a maximum of 400,000 of these shares available to grant as restricted stock awards. Each share issued as a restricted stock award counts as two shares towards the total shares available to award.

Under the 2016 Plan, the vesting date for each option award or restricted stock award is determined by an award committee and specified in the award agreement. In the case of restricted stock awards granted in lieu of cash payments of director's fees, the grant date is used as the vesting date.

As a result of the approval of the 2016 Plan, the First Financial Northwest, Inc. 2008 Equity Incentive Plan ("2008 Plan") was frozen and no additional awards will be made. As of June 30, 2016, there were 611,756 available stock options and 74,478 available restricted stock awards that are no longer available to be awarded under the 2008 Plan. Restricted stock awards and stock options that were granted under the 2008 Plan will continue to vest and be available for exercise, subject to the 2008 Plan provisions. At September 30, 2016, there were 1,371,896 total shares available

for grant under the 2016 Plan, including 385,948 shares available to be granted as restricted stock.

For the three months ended September 30, 2016 and 2015, total compensation expense for the Plan was $302,000, and $111,000, respectively, and the related income tax benefit was $106,000 and $39,000, respectively.

For the nine months ended September 30, 2016 and 2015, total compensation expense for the Plan was $505,000 and $330,000, respectively, and the related income tax benefit was $177,000 and $116,000, respectively.

Included in the above compensation for the nine months ended September 30, 2016, director's compensation of $180,000 was recognized as a result of the awarding and vesting of restricted shares in lieu of cash payments of directors' fees, with a related income tax benefit of $63,000.

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Stock Options

Under the 2008 Plan, stock option awards were granted with an exercise price equal to the market price of First Financial Northwest's common stock at the grant date. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date, and a contractual life of 10 years. Any unexercised stock options will expire ten years after the grant date or sooner in the event of the award recipient's death, disability or termination of service with the Company or the Bank.

Under the 2016 Plan, the exercise price and vesting period for stock options are determined by the award committee and specified in the award agreement, however, the exercise price shall not be less than the fair market value of a share as of the grant date. Any unexercised stock option will expire 10 years after the award date or sooner in the event of the award recipient's death, disability, retirement, or termination of service.

The fair value of each option award is estimated on the grant date using a Black-Scholes model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The historical volatility of the Company's stock price over a specified period of time is used for the expected volatility assumption. First Financial Northwest bases the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. First Financial Northwest elected to use the "Share-Based Payments" method permitted by the SEC to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at the midpoint.

A cashless exercise of vested stock options may occur by the option holder surrendering the number of options valued at the current stock price at the time of exercise to cover the total cost to exercise. The surrendered options are canceled and are unavailable for reissue.

A summary of the Company's stock option plan awards and activity for the three and nine months ended September 30, 2016, follows:

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
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(Unaudited)

| | For the Three Months Ended September 30, 2016 | | | |
|---|---|---|---|---|
| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term in Years | Aggregate Intrinsic Value |
| Outstanding at July 1, 2016 | 726,320 | $ 10.12 | | |
| Granted | — | | | |
| Exercised | (7,500 ) | 9.78 | | |
| Canceled | — | | | |
| Forfeited or expired | — | | | |
| Outstanding at September 30, 2016 | 718,820 | 10.12 | 4.56 | 2,908,520 |
| Vested and expected to vest assuming a 3% forfeiture rate over the vesting term | 713,090 | 10.12 | 4.53 | 2,891,228 |
| Exercisable at September 30, 2016 | 527,820 | 9.75 | 3.40 | 2,332,110 |

| | For the Nine Months Ended September 30, 2016 | | | |
|---|---|---|---|---|
| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term in Years | Aggregate Intrinsic Value |
| Outstanding at January 1, 2016 | 884,260 | $ 10.11 | | |
| Granted | — | | | |
| Exercised | (63,173 ) | 9.78 | | |
| Canceled | (82,267 ) | | | |
| Forfeited or expired | (20,000 ) | 12.05 | | |
| Outstanding at September 30, 2016 | 718,820 | 10.12 | 4.56 | 2,908,520 |
| Vested and expected to vest assuming a 3% forfeiture rate over the vesting term | 713,090 | 10.12 | 4.53 | 2,891,228 |
| Exercisable at September 30, 2016 | 527,820 | 9.75 | 3.40 | 2,332,110 |

As of September 30, 2016, there was $657,470 of total unrecognized compensation cost related to nonvested stock options granted under the 2008 Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 2.95 years. There were no stock options granted during the three and nine months ended September 30, 2016 under either the 2008 Plan or 2016 Plan.

Restricted Stock Awards

The 2008 Plan authorized the grant of restricted stock awards to directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the grant date. The restricted stock awards' fair value is equal to the stock price on the grant date. Shares awarded under this plan as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date.

The 2016 Plan authorizes the grant of restricted stock awards subject to vesting periods or terms as defined by the award committee and specified in the award agreement. Restricted stock awards granted in lieu of cash payments for directors' fees are subject to immediate vesting on the grant date unless the award agreement provides otherwise.

A summary of changes in nonvested restricted stock awards for the three and nine months ended September 30, 2016, follows:

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| | For the Three Months Ended September 30, 2016 | |
|---|---|---|
| | Shares | Weighted-Average Grant Date Fair Value |
| Nonvested at July 1, 2016 | 47,800 | $ 8.95 |
| Granted | — | |
| Vested | (9,700 ) | 8.97 |
| Canceled | (5,300 ) | 8.97 |
| Forfeited | — | |
| Nonvested at September 30, 2016 | 32,800 | 8.94 |
| Expected to vest assuming a 3% forfeiture rate over the vesting term | 31,816 | |

| | For the Nine Months Ended September 30, 2016 | |
|---|---|---|
| | Shares | Weighted-Average Grant Date Fair Value |
| Nonvested at January 1, 2016 | 47,800 | $ 8.95 |
| Granted | 14,052 | 12.81 |
| Vested | (23,752) | 10.83 |
| Canceled | (5,300 ) | 8.97 |
| Forfeited | — | |
| Nonvested at September 30, 2016 | 32,800 | 8.94 |
| Expected to vest assuming a 3% forfeiture rate over the vesting term | 31,816 | |

As of September 30, 2016, there was $222,433 of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.33 years.

Note 9 - Federal Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal income tax laws, and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax assets and liabilities.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more

likely than not that some or all of the deferred tax asset will be realized. At September 30, 2016, it was determined that the full deferred tax asset would be realized in future periods and no valuation allowance was required.

Our effective tax rate for the first nine months of 2016 was 30.1%. During the three months ended September 30, 2016, we recognized a $213,000 tax benefit as a result of a new tax regulation that allowed the Company to utilize a capital loss carryforward that was expected to be foregone at December 31, 2015. We recognized an additional tax benefit as a result of the



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exercise by officers and directors of certain non-qualified stock options. Estimated compensation expense is accrued to the deferred tax asset over the vesting period of the options. When these options were exercised, the actual stock price for our common stock was higher than previously estimated, resulting in an increase to actual compensation expense above the amount previously accrued and recognition of a tax benefit. Partially offsetting these benefits, we surrendered a $10.2 million BOLI policy during the second quarter of 2016, and used the proceeds to purchase a new BOLI policy. The increase in cash surrender value during the life of the policy was previously excluded from taxable income, however due to the early surrender of the policy, we recognized additional taxable noninterest income of $182,000 and incurred a 10% penalty of $18,000.

The Company has prepared federal tax returns through December 31, 2015, at which time the Company had an alternative minimum tax credit carryforward totaling $1.6 million which has no expiration date.

Note 10 - Earnings Per Share

Per the provisions of FASB ASC 260, Earnings Per Share, nonvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and are included in the computation of EPS pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. ESOP shares are considered outstanding for basic and diluted earnings per share when the shares are committed to be released. Certain of the Company's nonvested restricted stock awards qualify as participating securities.

Net income is allocated between the common stock and participating securities pursuant to the two-class method, based on their rights to receive dividends, participate in earnings, or absorb losses. Basic earnings per common shares is computed by dividing net earnings available to common shareholders by the weighted-average number of common shares outstanding during the period, excluding participating nonvested restricted shares.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the periods indicated:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (Dollars in thousands, except share data) | | | |
| Net income | $2,606 | $ 2,446 | $5,871 | $ 7,043 |
| Less: Earnings allocated to participating securities | (7 ) | (9 ) | $(16 ) | $ (26 ) |
| Earnings allocated to common shareholders | $2,599 | $ 2,437 | $5,855 | $ 7,017 |
| | | | | |
| Basic weighted average common shares outstanding | 11,859,683 | 13,372,573 | 12,329,815 | 13,719,522 |
| Dilutive stock options | 131,919 | 134,187 | 132,711 | 135,475 |
| Dilutive restricted stock grants | 20,350 | 21,562 | 18,853 | 23,552 |
| Diluted weighted average common shares outstanding | 12,011,952 | 13,528,322 | 12,481,379 | 13,878,549 |

| | | | | |
|---|---|---|---|---|
| Basic earnings per share | $0.22 | $ 0.18 | $0.47 | $ 0.51 |
| Diluted earnings per share | $0.22 | $ 0.18 | $0.47 | $ 0.51 |

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three and nine months ended September 30, 2016, options to purchase an additional 60,000 shares of common stock were not included in the computation of diluted earnings per share because the incremental shares under the treasury stock method of calculation resulted in them being anti-dilutive. For the three and nine months ended September 30, 2015, options to purchase an additional 165,000 and 225,000 shares of common stock, respectively, were excluded as their effect would be anti-dilutive.

Note 11 - Subsequent Events

Stock Repurchase Plan

On September 9, 2016, the Board of Directors authorized the repurchase of up to 1,500,000 shares of the Company's common stock, or 12.5% of the Company's outstanding shares. This plan expires on March 27, 2017. Subsequent to September 30, 2016, we repurchased 996,277 shares at an average price of $14.47 per share, bringing the total shares repurchased under this plan as of November 3, 2016 to 1,133,777 at an average price of $14.42 per share. On October 10, 2016, Joseph Stilwell filed an amendment to his Schedule 13D indicating that he and his affiliated entities had sold their entire holdings of stock in the Company.

Cash Flow Hedge

On October 25, 2016, the Bank entered into a Cash Flow Hedge agreement with a $50,000,000 notional, pay-fixed, receive floating swap. Under the terms of the swap, the Bank will pay a fixed rate of 1.34% for five years and receive three month LIBOR. Concurrently, the Bank borrowed $50,000,000 from the FHLB of Des Moines utilizing a three month fixed rate advance. The payment and interest reset dates will be the 25th of January, April, July, and October each year, at which time the three month LIBOR rate used for the swap and the three month FHLB advance will both reprice to the rates in effect at those dates. The Bank entered into the Cash Flow Hedge agreement as management determined this was a cost effective way to manage interest rate risk.

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

Forward-Looking Statements

Certain matters discussed in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” or similar or future or conditional verbs such as “may,” “will,” “should,” “would” and “could.” Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs, that may be affected by deterioration in the housing and commercial real estate markets, and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve Bank of San Francisco and our bank subsidiary by the Federal Deposit Insurance Corporation (“FDIC”), the Washington State Department of Financial Institutions, Division of Banks (“DFI”) or other regulatory authorities, including the possibility that any such regulatory authority may initiate an enforcement action against the Company or the Bank which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements or restrictions on us, any of which could adversely affect our liquidity and earnings; our ability to pay dividends on our common stock; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs

and expenses; the use of estimates in determining the fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other

rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") and the implementing regulations; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our filings with the U.S. Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended December 31, 2015 ("2015 Form 10-K"). Any of the forward-looking statements that we make in this Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

Overview

First Financial Northwest Bank ("the Bank") is a wholly-owned subsidiary of First Financial Northwest, Inc. ("the Company") and, as such, comprises substantially all of the activity for First Financial Northwest. First Financial Northwest Bank was a community-based savings bank until February 4, 2016, when the Bank converted to a Washington chartered commercial bank reflecting the commercial banking services it now provides to its customers. Our full-service banking office in Renton, Washington serves primarily King County, and also Pierce, Snohomish and Kitsap counties. Additional branches opened in Mill Creek, Washington in September 2015, Edmonds, Washington in March 2016, and The Landing in Renton, Washington in July 2016. Improved technology from the conversion to a new core data processor in August 2015 allows the Bank to better meet the needs of our customers as we seek to broaden the demographics of our customer base.

The Bank's business consists predominantly of attracting deposits from the general public, combined with borrowing from the Federal Home Loan Bank of Des Moines ("FHLB") and raising funds in the wholesale market, then utilizing these funds to originate one-to-four family residential, multifamily, commercial real estate, construction/land development, business, and consumer loans. Our current business strategy emphasizes commercial real estate, construction, one-to-four family residential, and multifamily lending. Recently, improvements in the economy, employment rates, stronger real estate prices, and a general lack of new housing inventory in certain areas in the Puget Sound region have led to our significantly increasing originations of construction loans for properties located in our market area. We anticipate that construction lending will continue to be a strong element of our total loan portfolio in future periods. We will continue to take a disciplined approach in our construction and land development lending by concentrating our efforts on smaller one-to-four residential loans to builders known to us. On a limited basis, we also will provide multifamily loans to developers with proven success in this type of construction. In addition, we are geographically expanding our loan portfolio through loan purchases or loan participations of commercial and multifamily real estate loans that are outside of our primary market area. We recently hired a loan officer with extensive experience in California to further support our efforts to geographically diversify our loan portfolio through direct loan originations, loan participations, or loan purchases.

In support of our strategic growth plan, the Bank is seeking niche expansion opportunities. We have employees with the language and experience to meet the specific deposit and lending needs of the Chinese/American community, including real estate developers involved in the EB-5 Immigrant Investor Program. In addition, we are developing a national line of business to originate and service aircraft loans. These loans will be collateralized by new or used, single-engine piston aircraft to light jets for business or personal use. Our aircraft loans will initially range in size

from $250,000 to $4.0 million and the primary focus of our underwriting guidelines will be on the asset value of the collateral rather than the ability of the borrower to repay the loan. We expect to begin originating loans in this area in the fourth quarter of 2016.

Our primary source of revenue is interest income, which is the income that we earn on our loans and investments. Interest expense is the interest that we pay on our deposits and borrowings. Net interest income is the difference between interest income and interest expense. Changes in levels of interest rates affect interest income and interest expense differently and, thus, impacts our net interest income.

An offset to net interest income is the provision for loan losses which is required to establish the allowance for loan and lease losses ("ALLL") at a level that adequately provides for probable losses inherent in our loan portfolio. As our loan portfolio increases, or due to an increase for probable losses inherent in our loan portfolio, our ALLL may increase, resulting in a decrease to net interest income. Improvements in loan risk ratings, increases in property values, or receipt of recoveries of amounts previously charged off may partially or fully offset any increase to ALLL due to loan growth or an increase in probable loan losses.



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Noninterest income is generated from various loan or deposit fees, increases in the cash surrender value of bank owned life insurance ("BOLI"), and revenue earned on our wealth management brokerage relationship. This income is increased or partially offset by any net gain or loss on sales of investment securities.

Our noninterest expenses consist primarily of salaries and employee benefits, professional fees, regulatory assessments, occupancy and equipment, and other general and administrative expenses. Salaries and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement, and other employee benefits. Professional fees include legal services, auditing and accounting services, computer support services, and other professional services in support of strategic plans. Occupancy and equipment expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of real estate taxes, depreciation expenses, maintenance, and costs of utilities. Also included in noninterest expense are changes to the Company's unfunded commitment reserve which are reflected in general and administrative expenses. This unfunded commitment reserve expense can vary significantly each quarter, based on the amount believed by management to be sufficient to absorb estimated probable losses related to unfunded credit facilities, and reflects changes in the amounts that the Company has committed to fund but has not yet disbursed.

Critical Accounting Policies

Our significant accounting policies are fundamental to understanding our results of operations and financial condition because they require that we use estimates and assumptions that may affect the value of our assets or liabilities and our financial results. These policies are critical because they require management to make difficult, subjective, and complex judgments about matters that are inherently uncertain and because it is likely that materially different amounts would be reported under different conditions or by using different assumptions. These policies govern the ALLL, the valuation of OREO, and the calculation of deferred taxes, fair values, and other-than-temporary impairments on the market value of investments. These policies and estimates are described in further detail in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies with the 2015 Form 10-K. There have not been any material changes in the Company's critical accounting policies and estimates as compared to the disclosure contained in the 2015 Form 10-K.

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

Total assets were $1.1 billion at September 30, 2016, an increase of 9.7%, from $979.9 million at December 31, 2015. The following table details the $94.8 million net change in the composition of our assets at September 30, 2016 from December 31, 2015.

| | Balance at September 30, 2016 | Change from December 31, 2015 | Percent Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Cash on hand and in banks | $5,803 | $90 | 1.6 % |
| Interest-earning deposits | 26,708 | (73,290) | (73.3) |
| Investments available-for-sale, at fair value | 133,865 | 4,300 | 3.3 |
| Loans receivable, net | 845,930 | 160,858 | 23.5 |
| Premises and equipment, net | 18,296 | 589 | 3.3 |
| FHLB stock, at cost | 10,031 | 3,894 | 63.5 |
| Accrued interest receivable | 3,378 | 410 | 13.8 |
| Deferred tax assets, net | 3,053 | (1,503) | (33.0) |
| OREO | 2,331 | (1,332) | (36.4) |

| | | | | |
|---|---|---|---|---|
| BOLI, net | 23,950 | 641 | 2.8 | |
| Prepaid expenses and other assets | 1,353 | 128 | 10.4 | |
| Total assets | $ 1,074,698 | $ 94,785 | 9.7 | % |

Interest-earning deposits. Our interest-earning deposits, consisting primarily of funds held at the Federal Reserve Bank of San Francisco, decreased by $73.3 million from December 31, 2015 to September 30, 2016 as lower yielding cash was used to partially fund the growth in higher yielding loans receivable.

Investments available-for-sale. Our investments available-for-sale portfolio increased by $4.3 million during the first nine months of 2016. During this period, we purchased $40.5 million of securities that included two subordinated debt instruments issued by well capitalized financial institutions located in southern California in the amounts of $5.0 million each, increasing our corporate bonds by $10.0 million. These notes carry fixed interest rates of 6.0% and 6.5% for the initial five years, then convert to floating rate instruments that reprice quarterly for the remainder of their ten year terms. In addition, we purchased tax exempt municipal bonds, mortgage backed securities, and one bond issued by the U.S. Small Business Administration with a combined yield at purchase of 3.07%. Partially funding these purchases, we sold $24.5 million of mortgage backed securities with a combined yield of 0.19%. At September 30, 2016, corporate bonds issued by financial institutions represented $24.0 million or 17.9% of our investments available-for-sale and municipal bonds represented $13.8 million or 10.3% of our investments available-for-sale. These purchases were part of our investment portfolio restructuring strategy to transition our investment portfolio to securities with longer maturity periods, higher yields, and primarily fixed rates in order to enhance our interest income.

In addition to the purchase and call activity, we received principal repayments of $12.4 million on our investments available-for-sale during the first nine months of 2016. The net unrealized gain of our investments available-for-sale had a pre-tax increase of $1.2 million during the nine months ended September 30, 2016.

The effective duration of the investments available-for-sale at September 30, 2016, was 3.6% as compared to 3.2% at December 31, 2015. Effective duration is a measure that attempts to quantify the anticipated percentage change in the value of an investment security (or portfolio) in the event of a 100 basis point change in market yields. Since the Bank's portfolio includes securities with embedded options (including call options on bonds and prepayment options on mortgage-backed securities), management believes that effective duration is an appropriate metric to use as a tool when analyzing the Bank's investment securities portfolio, as effective duration incorporates assumptions relating to such embedded options, including changes in cash flow assumptions as interest rates change.

Loans receivable. Net loans receivable increased $160.9 million during the first nine months of 2016. During this time period, we supplemented our loan originations by purchasing $58.3 million in performing residential and non-residential commercial real estate and multifamily loans from other financial institutions. The loans were purchased at a 1.8% - 3.0% premium and are intended to be held to maturity. Included in these commercial real estate loan purchases were $18.1 million of commercial real estate loans secured by properties located in Washington. The remaining balance of $40.2 million of commercial real estate loan purchases were secured by properties located in Arizona, California, Colorado, Oregon, and Utah, reflecting our efforts to geographically diversify our loan portfolio with loans meeting our investment and credit quality objectives.

The following table details the types of commercial real estate, multifamily and construction and development loans in our portfolio. The roll over construction loans and land loans reported as multifamily or commercial loans and $2.3 million of one-to-four family bridge loans reported as one-to-four family non-owner occupied loans elsewhere in this document have been reclassified as construction and land development loans for this presentation. We routinely monitor the concentrations of our commercial and construction loans to ensure we are in line with internally established limits. The Bank has set concentration guidelines of total commercial real estate, including residential, non-residential, and construction, should not exceed 550% of total risk-based capital. Construction and land development loans should not exceed 100% of total risk-based capital. At September 30, 2016, the Bank's concentrations were 446.9% for total commercial real estate loans and 97.1% for total construction and land development loans. Additionally, our commercial and multifamily real estate and construction/land development loan portfolios are subject to ongoing credit reviews performed by both independent loan review staff, as well as an external third-party review firm to assist with identifying potential adverse trends and risks in the portfolio allowing management to initiate timely corrective action, as necessary. Such reviews also assist with ensuring loan risk grades are accurately assigned and thereby properly accounted for in the ALLL. The review places emphasis on large borrowing relationships, stress testing, compliance with loan covenants as well as other risk factors warranting

enhanced review.



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| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| | (In thousands) | |
| Residential: | | |
| Multifamily | $109,033 | $ 114,724 |
| Micro-unit apartments | 26,381 | 8,023 |
| Total Residential | 135,414 | 122,747 |
| | | |
| Non-residential: | | |
| Office | 104,448 | 78,295 |
| Retail | 128,561 | 77,365 |
| Mobile home park and land | 23,120 | 23,630 |
| Warehouse | 15,399 | 17,845 |
| Storage | 34,988 | 40,238 |
| Mixed use | 22,688 | 6,838 |
| Total Non-residential | 329,204 | 244,211 |
| | | |
| Construction/land development: | | |
| Commercial non-residential | 31,709 | 17,058 |
| One-to-four family residential | 64,444 | 52,233 |
| Multifamily | 98,796 | 46,666 |
| Total construction and development | 194,949 | 115,957 |
| Total commercial, multifamily and construction loans | $659,567 | $ 482,915 |

During the first nine months of 2016, total construction loans in accordance with regulatory guidance increased by $79.0 million, including $49.3 million of multifamily construction loans that will roll over to permanent loans upon completion of the construction period with a corresponding increase in LIP of $14.6 million. At September 30, 2016, total construction loans were $194.9 million, including LIP of $68.5 million, of which $98.8 million and $64.4 million were for multifamily and one-to-four family construction projects, respectively. Non-construction multifamily loans increased during the first nine months of 2016 by $12.7 million. Commercial real estate, not including raw land, increased $85.0 million at September 30, 2016 as compared to December 31, 2015, with $26.9 million of these loans from California. The balances in business and consumer loans remained fairly stable during the first nine months of 2016. Offsetting these increases, our one-to-four family portfolio decreased by $2.1 million as competition for these loans remains high in this extended low rate environment.

The majority of our loan portfolio continues to be focused in our primary market area, however we are also seeking geographic diversification. The collateral underlying the pools of loans purchased during the nine months ended September 30, 2016 are located throughout the West Coast. In addition, we are pursuing opportunities for loan participations outside our primary market area that meet our investment and credit quality objectives. During the first quarter of 2016, we hired an employee in the state of California whose focus is directly originating new commercial and multifamily real estate loans as well as analyzing loan participation and loan purchase opportunities in the San Francisco Bay area. At September 30, 2016, total loans in California represent 3.1% of our portfolio. The following table details geographic concentrations in our loan portfolio, shown net of LIP:

| | At September 30, 2016 | | | | | | |
|---|---|---|---|---|---|---|---|
| | One-to-four family residential | Multifamily | Commercial real estate | Construction/land development | Business | Consumer | Total |
| | (In thousands) | | | | | | |
| King County | $188,460 | $ 102,538 | $ 178,154 | $ 62,613 | $ 8,014 | $ 5,749 | $545,528 |
| Pierce County | 40,939 | 16,404 | 36,731 | — | — | 541 | 94,615 |
| Snohomish County | 9,291 | 5,519 | 36,789 | 7,005 | 9 | 147 | 58,760 |
| Kitsap County | 4,000 | 5,910 | 961 | — | — | 78 | 10,949 |
| California | — | — | 26,933 | — | — | — | 26,933 |
| Other Washington Counties | 12,925 | 17,061 | 54,589 | 2,928 | — | 11 | 87,514 |
| Outside Washington and California | 290 | 11,654 | 22,963 | — | — | — | 34,907 |
| Total loans, net LIP | $255,905 | $ 159,086 | $ 357,120 | $ 72,546 | $ 8,023 | $ 6,526 | $859,206 |

Our five largest borrowing relationships, which represent 9.5% of our net loans, increased by $5.9 million from $76.1 million at December 31, 2015 to $82.0 million at September 30, 2016. However, the total number of loans represented by this group of borrowers decreased from 70 loans at December 31, 2015 to 23 loans at September 30, 2016. At September 30, 2016 all five borrowers were current on their loan payments. We monitor the performance of these borrowing relationships very closely due to their concentration risk in relation to the entire loan portfolio. The following table details our five largest lending relationships at September 30, 2016:

| Borrower [1] | Number of Loans | One-to-Four Family Residential [2] | Multifamily | Commercial Real Estate | Construction/ Land Development | Consumer | Aggregate Balance of Loans [3] |
|---|---|---|---|---|---|---|---|
| | | (Dollars in thousands) | | | | | |
| Real estate investor | 1 | $— | | $ 18,476 | | | $ 18,476 |
| Real estate investor | 11 | — | 16,750 | 843 | | | 17,593 |
| Real estate investor | 3 | 489 | | 15,146 | | | 15,635 |
| Real estate investor | 5 | 469 | — | 14,832 | | 100 | 15,401 |
| Real estate builder | 3 | — | | 8,820 | 6,028 | | 14,848 |
| Total | 23 | $958 | $ 16,750 | $ 58,117 | $ 6,028 | $ 100 | $ 81,953 |

[1] The composition of borrowers represented in the table may change between periods.
[2] All of the one-to-four family residential are owner occupied.
[3] Net of LIP.

The ALLL increased to $11.0 million at September 30, 2016 from $9.5 million at December 31, 2015 and represented 1.3% and 1.4% of total loans receivable at September 30, 2016 and December 31, 2015, respectively. The ALLL consists of two components, the general allowance and the specific reserves. The increase in the ALLL, primarily a result of growth in our loan portfolio, consisted of a $1.8 million increase in the general reserve and a $226,000 decrease in the specific reserves. For additional information, see "Comparison of Operating Results for the Three Months Ended September 30, 2016 and 2015-Provision for Loan Losses" discussed below.

We believe that the ALLL at September 30, 2016 was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will be proven correct in the future, that the actual amount of future losses will not exceed the amount of past provisions, or that any increased provisions that may be required will not adversely impact our financial condition and results of operations.

Future additions to the allowance may become necessary based upon changing economic conditions, the level of problem loans, business conditions, credit concentrations, increased loan balances, or changes in the underlying collateral of the loan portfolio. In addition, the determination of the amount of our ALLL is subject to review by bank regulators as part of the routine examination process, which may result



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in the establishment of additional loss reserves or the charge-off of specific loans against established loss reserves based upon their judgment of information available to them at the time of their examination.

As we work with our borrowers that face difficult financial circumstances, we explore various options available to minimize our risk of loss. At times, the best option for our customers and the Bank is to modify the loan for a period of time, usually one year or less. Certain loan modifications are accounted for as troubled debt restructured loans ("TDRs"). These modifications have included a reduction in interest rate on the loan for a period of time, advancing the maturity date of the loan, or allowing interest-only payments for a specific time frame. These modifications are granted only when there is a reasonable and attainable restructured loan plan that has been agreed to by the borrower and is considered to be in the Bank's best interest.

The following table presents a breakdown of our TDRs at the dates indicated:

| | September 30, 2016 | December 31, 2015 | Nine Month Change |
|---|---|---|---|
| Nonperforming TDRs: | | | |
| One-to-four family residential | $182 | $ 131 | $51 |
| Total nonperforming TDRs | 182 | 131 | 51 |
| Performing TDRs: | | | |
| One-to-four family residential | 27,268 | 35,099 | (7,831) |
| Multifamily | 1,572 | 1,594 | (22) |
| Commercial real estate | 4,917 | 5,392 | (475) |
| Consumer | 43 | 43 | — |
| Total performing TDRs | 33,800 | 42,128 | (8,328) |
| Total TDRs | $33,982 | $ 42,259 | $(8,277) |
| % TDRs classified as performing | 99.5 % | 99.7 % | |

Our TDRs decreased $8.3 million at September 30, 2016 compared to December 31, 2015 as a result of principal repayments and loan payoffs. At September 30, 2016, two TDRs were on nonaccrual status although current on their payments. There were no committed but undisbursed funds in connection with our TDRs and impaired loans. The largest TDR relationship at September 30, 2016, totaled $9.6 million and was comprised of $8.9 million in one-to-four family residential rental properties and $758,000 in owner occupied commercial property, all located in King County.

Loans are considered past due if a scheduled principal or interest payment is due and unpaid for 30 days or more. At September 30, 2016, total past due loans comprised 0.02% of total loans receivable, net of LIP, as compared to 0.18% at December 31, 2015.

Nonperforming assets decreased to $3.4 million at September 30, 2016, compared to $4.7 million at December 31, 2015. The following table presents detailed information on our nonperforming assets at the dates indicated:

| | September 30, 2016 | December 31, 2015 | Nine Month Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Nonperforming loans: | | | |
| One-to-four family residential | $986 | $ 996 | $(10 ) |
| Consumer | 87 | 89 | (2 ) |
| Total nonperforming loans | 1,073 | 1,085 | (12 ) |
| | | | |
| OREO | 2,331 | 3,663 | (1,332 ) |
| Total nonperforming assets [(1)] | $3,404 | $ 4,748 | $(1,344) |
| | | | |
| Nonperforming assets as a percent of total assets | 0.32 % | 0.48 % | |

[(1)] The difference between nonperforming assets reported above, and the totals reported by other industry sources, is due to their inclusion of all TDRs as nonperforming loans, although 99.5% of our TDRs were performing in accordance with their restructured terms at September 30, 2016. The remaining 0.5% of TDRs at September 30, 2016 that were nonperforming are reported above as nonperforming loans.

Nonaccrual loans are loans that are 90 days or more delinquent or other loans which, in management's opinion, the borrower is unable to meet scheduled payment obligations. Nonaccrual loans remained stable at $1.1 million at September 30, 2016, and December 31, 2015. During the first nine months of 2016, loans with a total balance of $153,000 were transferred to nonaccrual status and were offset by $119,000 in principal payments and payoffs of nonaccrual loans and $47,000 in charge-offs of consumer loans during this period.

The three largest nonaccrual loans in the loan portfolio at September 30, 2016, included a $310,000 owner occupied single family residence in Snohomish County, which is current on its loan payments, a $169,000 owner occupied single family residence in King County, and a $148,000 owner occupied single family residence in King County, which is current on its loan payments.

We continue to focus our efforts on converting nonaccrual loans to OREO and subsequently selling the properties. By taking ownership of these properties, we can generally convert nonearning assets into earning assets on a more timely basis than which may otherwise be the case. Our success in this area is reflected by the continued improved ratio of our nonperforming assets as a percent of total assets, which declined to 0.32% at September 30, 2016, compared to 0.48% at December 31, 2015.

OREO. OREO includes properties acquired by the Bank through foreclosure or acceptance of a deed in lieu of foreclosure. At September 30, 2016, OREO was $2.3 million, a decrease of $1.4 million from $3.7 million at December 31, 2015. The decrease in OREO during the first nine months of 2016 was a result of $1.1 million in property sales and $257,000 in market valuation adjustments. During the first nine months of 2016, the Bank sold a $164,000 non-residential land development project, a $728,000 commercial property, and a $182,000 parcel of a multi-parcel commercial property, generating a net loss of $87,000.

The three largest OREO properties at September 30, 2016 were an office building valued at $837,000 located in Pierce County, undeveloped land valued at $506,000 located in Kitsap County, and a retail building valued at $505,000 in Mason County.

The following table presents a breakdown of our OREO by county and number of properties at September 30, 2016:

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| | County | | | | | |
|---|---|---|---|---|---|---|
| | Pierce | Kitsap | Mason | Total OREO | Number of Properties | Percent of Total OREO |
| | (Dollars in thousands) | | | | | |
| OREO: | | | | | | |
| Commercial real estate [1] | $1,320 | $506 | $505 | $2,331 | 5 | 100.0% |
| Total OREO | $1,320 | $506 | $505 | $2,331 | 5 | 100.0% |

[1] Of the five properties classified as commercial real estate, two are office/retail buildings and three are undeveloped lots.

Deposits. During the first nine months of 2016, deposits increased $16.8 million to $692.2 million at September 30, 2016, compared to $675.4 million at December 31, 2015. Deposit accounts consisted of the following:

| | September 30, 2016 | Change from December 31, 2015 | Percent Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Noninterest-bearing | $33,060 | $3,668 | 12.5 % |
| NOW | 15,864 | (397) | (2.4) |
| Statement savings | 28,939 | 612 | 2.2 |
| Money market | 188,298 | (23,138) | (10.9) |
| Certificates of deposit, retail | 350,522 | 26,682 | 8.2 |
| Certificates of deposit, brokered | 75,488 | 9,337 | 14.1 |
| | $692,171 | $16,764 | 2.5 |

During the first nine months of 2016, total retail deposits increased $7.4 million primarily as a result of the increased customer base with our new branch locations. Noninterest checking increased $3.7 million in 2016 with $1.5 million of this attributed to the three new branch locations. Retail certificates of deposit increased $26.7 million with $11.0 million of this increase from our branch locations. The balances in our money market accounts related to short term deposits from large construction developers that are part of the EB-5 Immigrant Investor Program to fund development projects decreased from $62.8 million at December 31, 2015 to $11.3 million at September 30, 2016. The decrease in these accounts was partially offset by the addition of new money market accounts resulting in a net decrease of $23.1 million during the first nine months of 2016.

Brokered certificates of deposits increased by $9.3 million during the nine months ended September 30, 2016, as we redeemed $14.6 million of certificates and added $23.9 million of new brokered certificates of deposit, reducing the weighted average cost of these funds to 1.6%. While brokered certificates of deposit may carry a higher cost than our retail certificates, their remaining maturity periods of 22 to 52 months, along with the enhanced call features of these deposits, assist us in our efforts to manage interest rate risk.

At both September 30, 2016 and December 31, 2015, we held $23.7 million and $16.0 million in public funds, respectively, nearly all of which were retail certificates of deposit.

Advances. We use advances from the FHLB as an alternative funding source, to reduce interest rate risk, and to leverage our balance sheet. Total FHLB advances at September 30, 2016 and December 31, 2015 were $221.5 million and $125.5 million, respectively. During the first nine months of 2016, we paid off two advances at their scheduled

maturity dates for $34.0 million, which carried a 0.81% interest rate, and $20.0 million, which carried a 0.70% interest rate. We replaced these funds and borrowed additional funds in the form of $110.0 million in overnight fed funds and a $40.0 million seven year Member Option Variable-rate Advance from the FHLB. This advance will reprice monthly and allows prepayment without penalties on the repricing dates. Of our total FHLB advances, $160.0 million is due to mature in less than one year, with the remaining $61.5 million due in one to seven years.

Stockholders' Equity. Total stockholders' equity decreased $19.6 million during 2016 to $151.1 million at September 30, 2016, from $170.7 million at December 31, 2015 primarily due to common stock repurchases. Retained earnings increased $3.7 million to $46.6 million during the nine months ended September 30, 2016 due to $5.9 million of net income partially offset by $2.2 million of shareholder dividends.



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The following table shows cash dividends paid per share and the related dividend payout ratio for the periods indicated:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Dividend declared per common share | $0.06 | $0.06 | $0.18 | $0.18 |
| Dividend payout ratio [1] | 27.4 % | 33.3 % | 37.9 % | 35.3 % |

(1) Dividends paid per common share divided by basic earnings per common share

As part of the strategy to increase shareholder value, the Company repurchased a total of 1,868,112 shares during the nine months ended September 30, 2016. Under a plan from November 2, 2015 through April 27, 2016, the Company purchased 436,145 shares from January 1, 2016 through the expiration of the plan at an average price of $13.37. On August 9, 2016, the Company completed the repurchase of $18.1 million in shares through a self-tender offer announced July 13, 2016. On September 9, 2016, the Board of Directors authorized the repurchase of up to 1,500,000 shares of the Company's common stock, or 12.5% of the Company's outstanding shares. This plan expires on March 27, 2017. From September 9, 2016 through September 30, 2016, the Company repurchased 137,500 shares under the current plan.

Additional paid-in-capital decreased $25.3 million during the nine months ended September 30, 2016 as a combined result of $26.4 million used to repurchase shares, partially offset by increases of $318,000 from the exercise of stock options and $505,000 from stock-based compensation. Accumulated other comprehensive gain increased $1.1 million from an accumulated other comprehensive loss as a result of improvements in after-tax valuation adjustments on investments available-for-sale.

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

General. Net income for the three months ended September 30, 2016 was $2.6 million, or $0.22 per diluted share as compared to net income of $2.4 million, or $0.18 per diluted share for the quarter ended September 30, 2015. The $160,000 increase in net income during the third quarter of 2016 was primarily a result of increases in net interest income and noninterest income and decreases in noninterest expense and federal income tax expense reduced by an increase in the provision for loan losses.

Net Interest Income. Net interest income for the quarter ended September 30, 2016 increased $1.2 million to $8.9 million, as compared to $7.7 million for the second quarter in 2015 due primarily to growth in our interest income due to an increase in the average balance of interest-earning assets and the shift from lower yielding interest-earning deposits to higher yielding investment securities and loan receivables.

The following table details the change in net interest income due to changes in yield or cost, or changes in the average balance of the related asset or liability:

| | Three Months Ended September 30, 2016 Compared to September 30, 2015 | | |
|---|---|---|---|
| | Net Change | | |
| | Rate | Volume | Total |
| | (In thousands) | | |
| Interest-earning assets: | | | |
| Loan receivable, net | $(546) | $1,815 | $1,269 |
| Investments available-for-sale | 164 | 50 | 214 |
| Interest-earning deposits | 20 | (49) | (29) |
| FHLB stock | 26 | 4 | 30 |
| Total net change in income on interest-earning assets | (336) | 1,820 | 1,484 |
| Interest-bearing liabilities: | | | |
| NOW | 5 | — | 5 |
| Statement savings | — | 2 | 2 |
| Money market | 39 | 15 | 54 |
| Certificates of deposit, retail | 107 | 23 | 130 |
| Certificates of deposit, brokered | (37) | 22 | (15) |
| Advances from the FHLB | (75) | 113 | 38 |
| Total net change in expense on interest-bearing liabilities | 39 | 175 | 214 |
| Total net change in net interest income | $(375) | $1,645 | $1,270 |

The $1.3 million increase in loan interest income during the third quarter of 2016 as compared to the same period in 2015 was a result of a $138.8 million increase in the average outstanding loan balance partially offset by a decrease in yield of 27 basis points. Growth in our commercial, multifamily and construction real estate loans, including $58.3 million in purchased multifamily and commercial real estate loans during 2016, contributed significantly to the increase in the average loan balance.

During the third quarter of 2016, interest income from our investments available-for-sale increased by $214,000 as compared to the same period in 2015. The average balance of our investments available-for-sale for the three months ended September 30, 2016 increased by $10.6 million as compared to the same period last year as invested interest-earning deposits earning a nominal yield were placed into higher yielding securities. In addition, our investments available-for-sale portfolio was restructured through the sales of lower yielding investment securities, and utilizing the proceeds received to purchase higher yielding, long-term investment securities, resulted in a 49 basis point increase in the average yield of investments available-for-sale.

Partially offsetting the increase in interest income, interest expense increased by $214,000 for the three months ended September 30, 2016 as compared to the same period in 2015. The average balance of our interest-bearing liabilities increased in all of our funding sources yet the total cost of these funds remained stable. Notable changes occurred in brokered certificates of deposit as the 21 basis point decrease in the cost of these funds outweighed the $4.8 million increase in the average balance of these funds, resulting in a $15,000 decrease in interest expense. To support the growth in our loans receivable, we increased the average balance of FHLB advances by $47.3 million during the three months ended September 30, 2016. Replacements in maturing advances and new advances were taken as variable rate federal funds, thereby reducing the average cost of these funds by 16 basis points.

The following table compares detailed average balances, related interest income or interest expense, associated yields and rates, and the resulting net interest margin for the three months ended September 30, 2016 and 2015. Nonaccrual loans are included in the average balance of net loans receivable and are considered to carry a zero yield.

| | Three Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2016 | | | 2015 | | |
| | Average Balance | Interest Earned / Paid | Yield / Cost | Average Balance | Interest Earned / Paid | Yield / Cost |
| | (Dollars in thousands) | | | | | |
| Assets | | | | | | |
| Loans receivable, net | $804,014 | $9,967 | 4.92% | $665,183 | $8,698 | 5.19% |
| Investments available-for-sale | 133,258 | 792 | 2.36 | 122,685 | 578 | 1.87 |
| Interest-earning deposits | 28,275 | 38 | 0.53 | 105,901 | 67 | 0.25 |
| FHLB stock | 8,483 | 45 | 2.10 | 6,537 | 15 | 0.91 |
| Total interest-earning assets | 974,030 | 10,842 | 4.42 | 900,306 | 9,358 | 4.12 |
| Noninterest earning assets | 60,781 | | | 61,480 | | |
| Total average assets | $1,034,811 | | | $961,786 | | |
| | | | | | | |
| Liabilities and Stockholders' Equity | | | | | | |
| NOW | $18,018 | $9 | 0.20% | $17,578 | $4 | 0.09% |
| Statement savings | 30,902 | 12 | 0.15 | 26,436 | 10 | 0.15 |
| Money market | 185,089 | 211 | 0.45 | 169,420 | 157 | 0.37 |
| Certificates of deposit, retail | 341,685 | 1,021 | 1.19 | 333,141 | 891 | 1.06 |
| Certificates of deposit, brokered | 70,964 | 292 | 1.63 | 66,122 | 307 | 1.84 |
| Advances from the FHLB | 182,804 | 363 | 0.79 | 135,500 | 325 | 0.95 |
| Total interest-bearing liabilities | 829,462 | 1,908 | 0.91 | 748,197 | 1,694 | 0.90 |
| Noninterest bearing liabilities | 43,659 | | | 37,078 | | |
| Average equity | 161,690 | | | 176,511 | | |
| Total average liabilities and equity | $1,034,811 | | | $961,786 | | |
| Net interest income | | $8,934 | | | $7,664 | |
| Net interest margin | | | 3.64% | | | 3.38% |

Provision for Loan Losses. Management recognizes that loan losses may occur over the life of a loan and that the ALLL must be maintained at a level necessary to absorb specific losses on impaired loans and probable losses inherent in the loan portfolio. Our methodology for analyzing the ALLL consists of two components: general and specific reserves. The general reserve is determined by applying factors to our various groups of loans. Management considers factors such as charge-off history, the prevailing economy, the regulatory environment, competition, geographic and loan type concentrations, policy and underwriting standards, nature and volume of the loan portfolio, managements' experience level, our loan review and grading systems, the value of underlying collateral and the level of problem loans in assessing the ALLL. The specific reserve component is created when management believes that the collectability of a specific loan has been impaired and a loss is probable. The specific reserves are computed using current appraisals, listed sales prices, and other available information, less costs to complete, if any, and costs to sell the property. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or if future events differ from current estimates.

During the quarter ended September 30, 2016, management evaluated the adequacy of the ALLL and concluded that additional provision for loan losses in the amount of $900,000 was appropriate for the quarter. For the quarter ended September 30, 2015, a $700,000 recapture of the provision for loan losses was recorded. For the third quarter of 2016, the provision for loan losses was primarily a result of growth in our loan portfolio. In comparison, the recapture reported in the third quarter of 2015 was primarily a result of $265,000 recoveries and payoffs on $5.0 million of loans classified as "special mention".

The following table summarizes selected financial data related to our ALLL and loan portfolio. All loan balances and ratios are calculated using loan balances that are net of LIP.

| | At or For the Three Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| | (Dollars in thousands) | |
| Total loans receivable, net of LIP, end of period | $859,205 | $687,676 |
| Average loans receivable during period | 804,014 | 665,183 |
| ALLL balance at beginning of period | 10,134 | 10,603 |
| Provision (recapture of provision) for loan losses | 900 | (700) |
| Charge-offs: | | |
| One-to-four family | — | (2) |
| Consumer | (28) | (20) |
| Total charge-offs | (28) | (22) |
| Recoveries: | | |
| One-to-four family | — | 217 |
| Commercial real estate | — | 48 |
| Total recoveries | — | 265 |
| Net (charge-off) recovery | (28) | 243 |
| ALLL balance at end of period | $11,006 | $10,146 |
| ALLL as a percent of total loans, net of LIP | 1.28 % | 1.48 % |
| Ratio of net (charge-offs) recoveries to average net loans receivable (annualized) | (0.01) | 0.14 |

Noninterest Income. Noninterest income increased $226,000 to $673,000 for the quarter ended September 30, 2016, from $447,000 for the quarter ended September 30, 2015. The following table provides a detailed analysis of the changes in the components of noninterest income:

| | Three Months Ended September 30, 2016 | Change from Three Months ended September 30, 2015 | Percent Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Service fees on deposit accounts | $16 | $ 4 | 33.3 % |
| Loan service fees | 52 | (4) | (7.1) |
| Net gain on sale of investments | 33 | (52) | (61.2) |
| BOLI change in cash surrender value | 251 | 38 | 17.8 |
| Wealth management revenue | 165 | 123 | 292.9 |
| Other | 156 | 117 | 300.0 |
| Total noninterest income | $673 | $ 226 | 50.6 |

The increase in the quarter ended September 30, 2016, compared to the quarter ended September 30, 2015, was primarily a result of the $123,000 increase in income from our wealth management services. These services, which began in May 2015, allow us to offer a broader range of wealth management solutions to appropriately meet the needs of our customers. Other noninterest income increased by $117,000 for the quarter ended September 30, 2016 as compared to the same quarter in 2015 as a result of receipt of certain loan fees. The increase in noninterest income recognized on our BOLI policies reflects the increase in cash surrender value of these policies. We recognize the increase in cash surrender value of these policies, which represents the increase in underlying investments, as noninterest income, which assists in offsetting expenses for employee benefits. In addition, during the quarter ended June 30, 2016, we surrendered one $10.2 million BOLI policy which was replaced with a higher yielding policy.

Noninterest Expense. Noninterest expense decreased $127,000 to $5.3 million for the quarter ended September 30, 2016 from $5.4 million for the comparable quarter in 2015.

The following table provides a detailed analysis of the changes in the components of noninterest expense:



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| | Three Months Ended September 30, 2016 | Change from Three Months ended September 30, 2015 | Percent Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Salaries and employee benefits | $3,821 | $ 333 | 9.5 % |
| Occupancy and equipment | 467 | 80 | 20.7 |
| Professional fees | 458 | (14 ) | (3.0 ) |
| Data processing | 259 | 83 | 47.2 |
| OREO related expenses, net | (11 ) | (35 ) | (145.8) |
| Regulatory assessments | 82 | (37 ) | (31.1 ) |
| Insurance and bond premiums | 86 | (3 ) | (3.4 ) |
| Marketing | 67 | (36 ) | (35.0 ) |
| Other general and administrative | 25 | (498 ) | (95.2 ) |
| Total noninterest expense | $5,254 | $ (127 ) | (2.4 )% |

Expenses for salaries and employee benefits increased $333,000 for the third quarter of 2016 as compared to the same period in 2015 primarily as a result of increases in salaries and in the number of employees. As a result of our new branches and the development of new products, the number of employees increased from 107 at September 30, 2015 to 118 at September 30, 2016. In addition, annual increases occurred between the comparative periods.

More than offsetting this increase, other general and administrative expenses decreased $498,000 primarily as a result of a recapture in the reserve for unfunded commitments. This reserve is funded to absorb estimated probable losses related to unfunded credit facilities. For the quarter ended September 30, 2016, we determined a $373,000 recapture was appropriate. The strong credit quality metrics of the Company's loan portfolio resulted in improvements in the unfunded commitment reserve calculation methodology, resulting in this recapture. In comparison, we recognized a $178,000 additional expense for the quarter ended September 30, 2015.

Federal Income Tax Expense. Our statutory income tax rate is 35%. We recorded federal income tax provisions of $847,000 and $984,000 for the quarters ended September 30, 2016, and 2015, respectively, as a result of our consolidated pretax net income. For the quarter ended September 30, 2016, our tax provision was net of a $213,000 benefit from utilizing an otherwise expiring capital loss carryforward for our 2015 tax return that was filed during the quarter.

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

General. Net income for the nine months ended September 30, 2016 was $5.9 million, or $0.47 per diluted share as compared to net income of $7.0 million, or $0.51 per diluted share for the nine months ended September 30, 2015. Significantly contributing to the decline in net income during the first nine months of 2016 was the recognition of a $1.4 million provision for loan loss in 2016 as compared to a $1.3 recapture of provision in 2015. In addition, noninterest expense increased by $2.6 million. These decreases were partially offset by a $2.1 million increase in net interest income, $966,000 increase in noninterest income and a decrease in federal income tax provision of $972,000.

Net Interest Income. Net interest income for the nine months ended September 30, 2016 increased $2.1 million to $24.9 million, as compared to $22.8 million for the same period in 2015. The increase was primarily the result of the growth in our higher yielding interest-earning assets.

The following table details the change in net interest income due to changes in yield or cost, or changes in the average balance of the related asset or liability:

| | Nine Months Ended September 30, 2016 Compared to September 30, 2015 | | |
|---|---|---|---|
| | Net Change | | |
| | Rate | Volume | Total |
| | (In thousands) | | |
| Interest-earning assets: | | | |
| Loan receivable, net | $(1,055) | $2,865 | $1,810 |
| Investments available-for-sale | 468 | 171 | 639 |
| Interest-earning deposits | 100 | (98) | 2 |
| FHLB stock | 115 | 1 | 116 |
| Total net change in income on interest-earning assets | (372) | 2,939 | 2,567 |
| Interest-bearing liabilities: | | | |
| NOW | 5 | — | 5 |
| Statement savings | 3 | 4 | 7 |
| Money market | 127 | 110 | 237 |
| Certificates of deposit, retail | 286 | (96) | 190 |
| Certificates of deposit, brokered | (20) | 34 | 14 |
| Advances from the FHLB | (84) | 54 | (30) |
| Total net change in expense on interest-bearing liabilities | 317 | 106 | 423 |
| Total net change in net interest income | $(689) | $2,833 | $2,144 |

Average loans receivable increased $73.5 million for the nine months ended September 30, 2016 as compared to the same period in 2015 while the average yield decreased to 5.02% from 5.21% for the nine months ended September 30, 2016 and 2015, respectively. Contributing to the growth of our loan portfolio, we purchased $58.3 million in commercial real estate loans in 2016 that were purchased at a 1.8% - 3.0% premium, which is amortized against interest income over the remaining maturity of the loans.

Interest income on our investments available-for-sale increased $639,000 for the nine months ended September 30, 2016 as compared to the same period in 2015 primarily as a result of the 47 basis point increase in the yield on these assets. We have continued to restructure our portfolio of these securities to include additional longer term higher-yielding investment securities to increase earnings from our investment portfolio.

The Federal Reserve Bank's federal funds rate increase in December 2015 positively impacted the rate paid on our interest-earning deposits. The average rate earned on interest-earning deposits increased 26 basis points for the nine months ended September 30, 2016, as compared to the same period in 2015. The increase in interest due to the rate increase was largely offset by the decrease in our average balance of these deposits, as we shifted these funds to higher yielding assets during 2016.

Partially offsetting the increase in interest income, our interest expense increased $423,000 for the nine months ended September 30, 2016 as compared to the same period in 2015. The increase was a combined result of a $44.0 million increase in the average balance of our interest-bearing liabilities and a two basis point increase in the overall cost of these funds. While the average balance of our FHLB advances increased by $7.6 million, total year-to-date interest paid decreased by $30,000 year over year as a result of an eight basis point decrease in the cost of these funds. Maturing longer-term fixed rate advances were replaced by short-term, variable rate advances, thereby significantly reducing the cost of these borrowings. In addition, the early redemption of several brokered certificates of deposit and securing of new brokered certificates at lower rates helped to offset the increased interest due to the increase in

volume of these funds. Interest expense on money market accounts increased $237,000 for the first nine months of 2016 as a combined result of increases in the average balance and rate paid for these deposits. Further contributing to the increase in interest expense, an 11 basis point increase in the cost of our retail certificates of deposit outweighed the $12.3 million decrease in the average balance of these deposits resulting in $190,000 additional interest expense for the nine months ended September 30, 2016 as compared to the same period in 2015.

The following table compares detailed average balances, associated yields and rates, and the resulting changes in interest and dividend income or expense for the nine months ended September 30, 2016 and 2015. Nonaccrual loans are included in the average balance of net loans receivable and are considered to carry a zero yield.

| | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2016 | | | 2015 | | |
| | Average Balance | Interest Earned / Paid | Yield or Cost | Average Balance | Interest Earned / Paid | Yield or Cost |
| | (Dollars in thousands) | | | | | |
| Assets | | | | | | |
| Loans receivable, net | $739,312 | $27,742 | 5.02% | $665,765 | $25,932 | 5.21% |
| Investments available-for-sale | 132,471 | 2,224 | 2.24 | 119,572 | 1,585 | 1.77 |
| Interest-earning deposits | 51,855 | 198 | 0.51 | 103,557 | 196 | 0.25 |
| FHLB stock | 6,878 | 136 | 2.64 | 6,630 | 20 | 0.40 |
| Total interest-earning assets | 930,516 | 30,300 | 4.35 | 895,524 | 27,733 | 4.14 |
| Noninterest earning assets | 59,127 | | | 56,699 | | |
| Total average assets | $989,643 | | | $952,223 | | |
| | | | | | | |
| Liabilities and Stockholders' Equity | | | | | | |
| NOW | $17,534 | $18 | 0.14% | $18,100 | $13 | 0.10% |
| Statement savings | 29,461 | 35 | 0.16 | 25,546 | 28 | 0.15 |
| Money market | 198,958 | 636 | 0.43 | 156,100 | 399 | 0.34 |
| Certificates of deposit, retail | 329,622 | 2,867 | 1.16 | 341,897 | 2,677 | 1.05 |
| Certificates of deposit, brokered | 67,345 | 913 | 1.81 | 64,875 | 899 | 1.85 |
| Advances from the FHLB | 143,092 | 933 | 0.87 | 135,500 | 963 | 0.95 |
| Total interest-bearing liabilities | 786,012 | 5,402 | 0.92 | 742,018 | 4,979 | 0.90 |
| Noninterest bearing liabilities | 36,545 | | | 30,472 | | |
| Average equity | 167,086 | | | 179,733 | | |
| Total average liabilities and equity | $989,643 | | | $952,223 | | |
| Net interest income | | $24,898 | | | $22,754 | |
| Net interest margin | | | 3.58% | | | 3.40% |

Provision for Loan Losses. During the nine months ended September 30, 2016, management evaluated the adequacy of the ALLL and concluded that additional provision for loan losses in the amount of $1.4 million was appropriate for the period. The provision during the first nine months of 2016 was primarily a reflection of the $160.9 million growth in net loans receivable. For 2015, the first nine month's recapture of $1.3 million was primarily a result of net recoveries of $955,000 and the repayment of $5.0 million of loans graded as "special mention", which reduced the amount required to be set aside in the general reserve.

The following table summarizes selected financial data related to our ALLL and loan portfolio. All loan balances and ratios are calculated using loan balances that are net of LIP.

| | At or For the Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| | (Dollars in thousands) | |
| Total loans receivable, net of LIP, end of period | $859,206 | $687,676 |
| Average loans receivable during period | 739,312 | 665,765 |
| ALLL balance at beginning of period | 9,463 | 10,491 |
| Provision (recapture of provision) for loan losses | 1,400 | (1,300) |
| Charge-offs: | | |
| One-to-four family | — | (27) |
| Multifamily | — | (281) |
| Consumer | (47) | (54) |
| Total charge-offs | (47) | (362) |
| Recoveries: | | |
| One-to-four family | 85 | 908 |
| Commercial real estate | 104 | 105 |
| Business | — | 3 |
| Consumer | 1 | 301 |
| Total recoveries | 190 | 1,317 |
| Net recovery | 143 | 955 |
| ALLL balance at end of period | $11,006 | $10,146 |
| ALLL as a percent of total loans, net of LIP | 1.28 % | 1.48 % |
| Ratio of net recoveries to average net loans receivable (annualized) | 0.03 | 0.19 |

Noninterest Income. Noninterest income increased $966,000 to $1.9 million for the nine months ended September 30, 2016, from $895,000 for the same period in 2015. The following table provides a detailed analysis of the changes in the components of noninterest income:

| | Nine Months Ended September 30, 2016 | Change from Nine Months Ended September 30, 2015 | Percent Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Service fees on deposit accounts | $60 | $ 5 | 9.1 % |
| Loan service fees | 181 | 70 | 63.1 |
| Net gain on sale of investments | 33 | (52) | (61.2) |
| BOLI change in cash surrender value | 641 | 272 | 73.7 |
| Wealth management revenue | 656 | 592 | 925.0 |
| Other | 290 | 79 | 37.4 |
| Total noninterest income | $1,861 | $ 966 | 107.9 |

The $272,000 increase in noninterest BOLI income was primarily a result of $20.0 million of BOLI policies purchased in April 2015 and the surrender of one $10.2 million BOLI policy which was replaced with a higher yielding policy. Wealth management revenue increased by $592,000 for the first three quarters of 2016 as compared to the same period in 2015. The commissions recognized in 2015 represent the initial two months of the Company offering wealth management services.

Noninterest Expense. Noninterest expense increased $2.6 million for the nine months ended September 30, 2016 as compared to the same period in 2015.

The following table provides a detailed analysis of the changes in the components of noninterest expense:



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| | Nine Months Ended September 30, 2016 | Change from Nine Months Ended September 30, 2015 | Percent Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Salaries and employee benefits | $11,436 | $ 1,283 | 12.6 % |
| Occupancy and equipment | 1,463 | 424 | 40.8 |
| Professional fees | 1,487 | 203 | 15.8 |
| Data processing | 700 | 177 | 33.8 |
| Loss (gain) on sales of OREO property, net | 87 | 618 | (116.4 ) |
| OREO market value adjustments | 257 | 252 | 5,040.0 |
| OREO-related expenses, net | (45 ) | (62 ) | (364.7 ) |
| Regulatory assessments | 319 | (32 ) | (9.1 ) |
| Insurance and bond premiums | 260 | (10 ) | (3.7 ) |
| Marketing | 145 | (45 ) | (23.7 ) |
| Other general and administrative | 990 | (254 ) | (20.4 ) |
| Total noninterest expense | $17,099 | $ 2,554 | 17.6 % |

Salaries and employee benefits expense increased $1.3 million for the first nine months of 2016 as compared to the same period in 2015. The number of employees increased from September 30, 2015 to September 30, 2016, as we added employees to support our core conversion project and branch expansions. Occupancy and equipment expense increased by $424,000 as a result of the addition of three leases for the Mill Creek, Edmonds, and Renton Landing branches.

The loss on sale of OREO properties resulted in an increase to noninterest expense of $618,000 in the first nine months of 2016 as compared to the same period in 2015. During the first nine months of 2015, sales of seven OREO properties for $5.5 million generated a $531,000 net gain. In comparison, for the same period in 2016, sales of two OREO properties plus a portion of a multi-parcel property for $988,000 generated a net loss of $87,000. In addition, market valuation adjustments to properties in our OREO inventory resulted in additional $257,000 expense for the first nine months of 2016 as compared to only $5,000 for the same period in 2015. A land development project in Kitsap County was written down based on a purchase and sale agreement received in the first quarter of 2016. The sale subsequently fell through, but was deemed to represent the market value of the property.

General and administrative expenses decreased by $254,000 primarily as a result of the $201,000 recapture in the reserve for unfunded commitments for the nine months ended September 30, 2016 as compared to a $253,000 expense for the nine months ended September 30, 2015. During 2016, the Company modified the calculation methodology for the reserve based on the strong credit quality of its loan portfolio. Partially offsetting this decrease, subscription expense increased by $43,000 and state taxes increased by $47,000 as a result of increased taxable income and new local taxes in 2016.

Federal Income Tax Expense. Our statutory income tax rate is 35%. We recorded federal income tax provisions of $2.4 million and $3.4 million for the year-to-date ended September 30, 2016, and 2015 as a result of our consolidated net income. Our effective tax rate for the nine months ended September 30, 2016 was 30.1% as partially a result of the early surrender of a BOLI policy, as discussed above. In addition, our tax provision was net of a $213,000 benefit from utilizing an otherwise expiring capital loss carryforward for our 2015 tax return that was filed in September 2016.

Liquidity

We are required to have enough cash flow in order to maintain sufficient liquidity to ensure a safe and sound operation. We maintain cash flows above the minimum level believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. On a daily basis, we review and update cash flow projections to ensure that adequate liquidity is maintained.

Our primary sources of funds are customer deposits, cash flow from the loan and investment portfolios, advances from the FHLB, and to a lesser extent, brokered certificates of deposit. These funds, together with equity, are used to make loans, acquire investment securities and other assets, and fund continuing operations. At September 30, 2016, retail certificates of deposit scheduled to mature in one year or less totaled $162.9 million. Management's practice is to maintain deposit rates at levels that are competitive with other local financial institutions. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions



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and competition. We measure our liquidity based on our ability to fund our assets and to meet liability obligations when they come due. Liquidity (and funding) risk occurs when funds cannot be raised at reasonable prices or in a reasonable time frame to meet our normal or unanticipated obligations. We regularly monitor the mix between our assets and our liabilities to manage effectively our liquidity and funding requirements.

When deposits are not readily available and/or cost effective to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to: advances from the FHLB, wholesale funding, brokered deposits, federal funds purchased and dealer repurchase agreements, as well as other short-term alternatives. These funding sources are generally collateral dependent. We may also liquidate assets to meet our funding needs. The balance of our investments available-for-sale increased $4.3 million from December 31, 2015 to $133.9 million at September 30, 2016 and represents a ready source of cash if needed. The balance of our interest-earning deposits decreased by $73.3 million from December 31, 2015 to September 30, 2016, as we shifted cash into higher yielding assets. At September 30, 2016, the Bank maintained credit facilities with the FHLB totaling $348.5 million with an outstanding balance of $221.5 million. At September 30, 2016, we also had available a total of $35.0 million credit facilities with other financial institutions, with no balance outstanding. For additional information, see the Consolidated Statements of Cash Flows in Item 1 of this Form 10-Q.

To assist in our funds acquisition and interest rate risk management efforts, management utilizes the national brokered deposit market and maintained a balance at September 30, 2016 of $75.5 million of brokered certificates of deposit. In contrast to most retail certificate of deposit offerings which provide the depositor with an option to withdraw their funds prior to maturity, subject to an early withdrawal penalty, certificates of deposit acquired in the brokered market limits the depositor ability to withdraw the funds before the end of the term (except in the case of death or adjudication of incompetence of a depositor) which greatly reduces early redemption risk associated with retail deposits. This strategy may include, but is not necessarily limited to, raising longer term deposits (with terms greater than three years) that assist the Bank in its interest rate risk management efforts. At September 30, 2016, brokered certificates of deposit had a remaining weighted-average maturity of 2.8 years. Most of these certificates also provide the Bank the option to redeem the deposit after six months, a favorable distinction compared to retail certificate of deposit terms that are offered in our local market. With these redemption limitations and call features, the cost of these brokered deposits is generally higher than our retail certificate of deposit offerings. Consequently, as we increase our brokered deposits, our cost of funds may increase.

First Financial Northwest is a separate legal entity from the Bank and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. First Financial Northwest's primary sources of funds consist of dividends from the Bank, although there are regulatory restrictions on the ability of the Bank to pay dividends. At September 30, 2016, the Company (on an unconsolidated basis) had liquid assets of $25.8 million and short-term liabilities of $156,000.

On a monthly basis, we estimate our liquidity sources and needs for the next six months. Also, we determine funding concentrations and our need for sources of funds other than deposits. This information is used by our Asset/Liability Management Committee ("ALCO") in forecasting funding needs and investing opportunities. We believe that our current liquidity position and our expected operating results are sufficient to fund all of our existing commitments.

Commitments and Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and the unused portions of lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Commitments to extend credit and lines of credit are not recorded as an asset or liability by us until the instrument is exercised. At September 30, 2016 and December 31, 2015, we had no commitments to originate loans for sale.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We evaluate each customer's creditworthiness on a case-by-case basis. The amount of the collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the customer. The amount and type of collateral required varies, but may include real estate and income-producing commercial properties.

The following table summarizes our outstanding commitments to advance additional amounts pursuant to outstanding lines of credit and to disburse funds related to our construction loans at September 30, 2016:

| | Amount of Commitment Expiration | | | | |
|---|---|---|---|---|---|
| | Total Amounts Committed | Through One Year | After One Through Three Years | After Three Through Five Years | After Five Years |
| | (In thousands) | | | | |
| Unused portion of lines of credit | $19,971 | $2,528 | $11,749 | $3,452 | $2,242 |
| Undisbursed portion of construction loans | 68,492 | 28,920 | 39,572 | — | — |
| Total commitments | $88,463 | $31,448 | $51,321 | $3,452 | $2,242 |

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

As of September 30, 2016, the Bank had three operating leases with initial terms of 5 to 5.5 years and carry minimum lease payments of $14,000 per month. All three leases offer extension periods.

First Financial Northwest and its subsidiaries from time to time are involved in various claims and legal actions arising in the ordinary course of business. There are currently no matters that in the opinion of management would have a material adverse effect on First Financial Northwest's consolidated financial position, results of operation, or liquidity.

Capital

At September 30, 2016, stockholders' equity totaled $151.1 million, or 14.06% of total assets. Our book value per share of common stock was $12.70 at September 30, 2016 compared to $12.40 at December 31, 2015. Consistent with our goal to operate a sound and profitable financial organization, we actively seek to maintain a "well-capitalized" status in accordance with regulatory standards.

As of September 30, 2016, the Bank and consolidated Company exceeded all regulatory capital requirements and the Bank was considered "well capitalized" under regulatory capital guidelines of the FDIC. The following table provides our capital requirements and actual results.

| | At September 30, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Minimum Capital Adequacy Purposes | | To be Categorized as "Well Capitalized" | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (dollars in thousands) | | | | | |
| Tier I leverage capital (to average assets) | | | | | | |
| Bank only | $117,333 | 11.37% | $41,275 | 4.00% | $51,594 | 5.00 % |
| Consolidated | 150,723 | 14.60 | 41,292 | 4.00 | 51,615 | 5.00 |
| Common equity tier I ("CET1") (to risk-weighted assets) | | | | | | |
| Bank only | 117,333 | 13.13 | 40,215 | 4.50 | 58,088 | 6.50 |
| Consolidated | 150,723 | 16.81 | 40,356 | 4.50 | 58,292 | 6.50 |
| Tier I risk-based capital (to risk-weighted assets) | | | | | | |
| Bank only | 117,333 | 13.13 | 53,620 | 6.00 | 71,493 | 8.00 |
| Consolidated | 150,723 | 16.81 | 53,808 | 6.00 | 71,744 | 8.00 |
| Total risk-based capital (to risk-weighted assets) | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Bank only | 128,505 | 14.38 | 71,493 | 8.00 | 89,366 | 10.00 |
| Consolidated | 161,936 | 18.06 | 71,744 | 8.00 | 89,680 | 10.00 |

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement began to be phased in starting in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

General. Our Board of Directors has approved an asset/liability management policy to guide management in maximizing net interest income by managing the differences in terms between interest-earning assets and interest-bearing liabilities while maintaining acceptable levels of liquidity, capital adequacy, interest rate sensitivity, credit risk, and profitability. The policy established an ALCO, comprised of certain members of senior management and the Board of Directors. The Committee's purpose is to manage, coordinate, and communicate our asset/liability position consistent with our business plan and Board-approved policy. The ALCO meets quarterly to review various areas including:

- economic conditions;
- interest rate outlook;
- asset/liability mix;
- interest rate risk sensitivity;
- current market opportunities to promote specific products;
- historical financial results;
- projected financial results; and
- capital position.

Additionally, the Committee reviews current and projected liquidity needs. As part of its procedures, the ALCO regularly reviews our interest rate risk by modeling the impact that changes in interest rates may have on earnings, particularly net interest income. The market value of portfolio equity, which is the net present value of an institution's existing assets less its liabilities and off-balance sheet instruments, is also modeled under several scenarios of changing interest rates. In both cases, results are evaluated and compared with the maximum potential change that is authorized by the Board of Directors.

Our Risk When Interest Rates Change. The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market interest rates change over time. Our loans generally have longer maturities than our deposits. Accordingly, our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is our most significant market risk.

We have utilized the following strategies in our efforts to manage interest rate risk:

- we have attempted, where possible, to extend the maturities of our deposits which typically fund our long-term assets;
- we have invested in securities with relatively short average lives, generally less than eight years; and,
- we have added adjustable-rate securities to our investment portfolio.

We have evaluated the use of derivative instruments to limit the impact of interest rate changes on earnings, prepayment penalties and cash flows and to lower our cost of borrowing while taking into account variable interest rate risk. At September 30, 2016, we did not have any derivative financial instruments or trading accounts for any class of financial instruments, however, on October 25, 2016, the Bank entered into a Cash Flow Hedge agreement.

For more information, see Note 11 - Subsequent Events, Cash Flow Hedge, in Item 1 of this report. We are using interest rate swaps as a tool to lower the cost of certain FHLB advances as compared to the fixed rates offered by the FHLB for its longer term advances. Interest rate contracts, however, may expose us to the risk of loss associated with variations in the spread between the interest rate contract and the hedged item. In addition, these contracts carry volatility risk that the expected uncertainty relating to the price of the underlying asset differs from what is anticipated. If interest rate swaps we enter into prove ineffective, it could result in volatility in our operating results, including potential losses, which could have a material adverse effect on our results of operations and cash flows.



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Brokered Deposits. During the third quarter of 2014, management added the national brokered deposit market as an additional source of funds and to assist efforts in managing interest rate risk. Utilizing brokered deposits might result in increased regulatory scrutiny, as such deposits are not viewed as favorably as core retail deposits and there can be no assurance that the Bank will be allowed to include brokered deposits in its deposit mix in the future. While management will attempt to weigh the benefits of brokered deposits against the costs and risks, there can be no assurance that its conclusions will necessarily be aligned with those of the Bank's regulators.

How We Measure the Risk of Interest Rate Changes. We monitor our interest rate sensitivity on a quarterly basis to measure the change in net interest income in varying rate environments. Management uses various assumptions to evaluate the sensitivity of our operations to changes in interest rates. Although management believes these assumptions are reasonable, the interest rate sensitivity of our assets and liabilities on net interest income and the market value of portfolio equity could vary substantially if different assumptions were used or actual experience differs from these assumptions. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react differently to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities lag behind changes in market interest rates. Non-uniform changes and fluctuations in market interest rates across various maturities will also affect the results presented. In addition, certain assets, such as adjustable-rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. A portion of our adjustable-rate loans have interest rate floors below which the loan's contractual interest rate may not adjust. Approximately 42.8% of our total loans, net LIP, were adjustable-rate loans at September 30, 2016. At that date, $196.0 million, or 53.3% of these loans were at their floor, with a weighted-average interest rate of 4.3%.

The inability of our loans to adjust downward can contribute to increased income in periods of declining interest rates. However, when loans are at their floors, there is a risk that our interest income may not increase as rapidly as our cost of funds during periods of increasing interest rates. Furthermore, in the event of a significant change in interest rates, prepayment and early withdrawal levels would likely deviate from those assumed. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. We consider all these factors in monitoring our interest rate exposure.

The assumptions we use are based upon a combination of proprietary and market data that reflect historical results and current market conditions. These assumptions relate to interest rates, loan prepayments, deposit decay rates and the market value of certain assets under the various interest rate scenarios. We use market data to determine prepayments and maturities of loans, investments and borrowings and use our own assumptions on deposit decay rates. The exception to this is time deposits, which are modeled to reprice to market rates upon their stated maturities. We also assume that non-maturity deposits can be maintained with rate adjustments not directly proportionate to the change in market interest rates, based upon our historical deposit decay rates which are substantially lower than market decay rates. We have demonstrated in the past that the tiering structure of our deposit accounts during changing rate environments results in relatively lower volatility and less than market rate changes in our interest expense for deposits. We tier our deposit accounts by balance and rate, whereby higher balances within an account earn higher rates of interest. Therefore, deposits that are not very rate sensitive (generally, lower balance tiers) are separated from deposits that are rate sensitive (generally, higher balance tiers). When interest rates rise, we do not have to raise interest rates proportionately on less rate sensitive accounts to retain these deposits. These assumptions are based upon our analysis of our customer base, competitive factors and historical experience.

Our income simulation model examines changes in net interest income in which interest rates were assumed to remain at their base level, instantaneously increase by 100, 200 and 300 basis points or decline immediately by 100 basis points. Reductions of rates by 200 and 300 basis points were not reported due to the current low rate environment.

The following table illustrates the change in our net interest income at September 30, 2016 that would occur in the event of an instantaneous change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

Net Interest Income Change at September 30, 2016

| Basis Point Change in Rates | Net Interest Income | % Change |
|---|---|---|
| (Dollars in thousands) | | |
| +300 | $31,389 | (9.81)% |
| +200 | 32,553 | (6.46) |
| +100 | 33,734 | (3.07) |
| Base | 34,802 | — |
| (100) | 35,465 | 1.91 |

The following table illustrates the change in our net portfolio value ("NPV") at September 30, 2016 that would occur in the event of an immediate change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

| Basis Point | | | | Net Portfolio as % of | | Market |
|---|---|---|---|---|---|---|
| Change in | Net Portfolio Value [1] | | | Portfolio Value of Assets | | Value of |
| Rates | Amount | $ Change [2] | % Change | NPV Ratio [3] | % Change [4] | Assets [5] |
| | (Dollars in thousands) | | | | | |
| +300 | $128,269 | $(40,169) | (23.85)% | 12.66% | (3.68)% | $1,013,409 |
| +200 | 142,393 | (26,045) | (15.46) | 13.69 | (2.39) | 1,039,876 |
| +100 | 156,958 | (11,480) | (6.82) | 14.71 | (1.05) | 1,067,365 |
| Base | 168,438 | — | — | 15.43 | — | 1,091,476 |
| (100) | 174,098 | 5,660 | 3.36 | 15.66 | 0.52 | 1,111,458 |

(1) The net portfolio value is the difference between the present value of the discounted cash flows of assets and liabilities and represents the market value of the Company's equity for any given interest rate scenario. Net portfolio value is useful for determining, on a market value basis, how equity changes in response to various interest rate scenarios. Large changes in net portfolio value reflect increased interest rate sensitivity and generally more volatile earnings streams.
(2) The increase or decrease in net portfolio value at the indicated interest rates compared to the net portfolio value assuming no change in interest rates.
(3) Net portfolio value divided by the market value of assets.
(4) The increase or decrease in the net portfolio value divided by the market value of assets.
(5) The market value of assets represents the value of assets under the various interest rate scenarios and reflects the sensitivity of those assets to interest rate changes.

The net interest income and net portfolio value tables presented above are predicated upon a stable balance sheet with no growth or change in asset or liability mix. In addition, the net portfolio value is based upon the present value of discounted cash flows using our estimates of current replacement rates to discount the cash flows. The effects of changes in interest rates in the net interest income table are based upon a cash flow simulation of our existing assets

and liabilities and assuming that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. Delinquency rates may change when interest rates change as a result of changes in the loan portfolio mix, underwriting conditions, loan terms or changes in economic conditions that have a delayed effect on the portfolio. Even if interest rates change in the designated amounts, there can be no assurance that our assets and liabilities would perform as set forth above. Also, a change in U.S. Treasury rates in the designated amounts accompanied by a change in the shape of the Treasury yield curve would cause changes to the net portfolio value and net interest income other than those indicated above.



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At September 30, 2016, we did not have any derivative financial instruments or trading accounts for any class of financial instruments, nor have we engaged in hedging activities or purchased off-balance sheet derivative instruments. However, we continue to review such instruments and may utilize them for interest rate risk management in the future. Interest rate risk continues to be one of our primary risks, as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

Item 4. Controls and Procedures

The management of First Financial Northwest, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 ("Exchange Act"). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Additionally, in designing disclosure controls and procedures, our management was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Furthermore, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

(a) Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2016, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in Internal Controls: In the quarter ended September 30, 2016, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II
Item 1. Legal Proceedings

From time to time, we are engaged in various legal proceedings in the ordinary course of business, none of which are currently considered to have a material impact on our financial position or results of operations.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of our 2015 Form 10-K.

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

(a) Not applicable

(b) Not applicable

(c) The following table summarizes First Financial Northwest's common stock repurchases during the third quarter of 2016:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Repurchased as Part of Publicly Announced Plan | Maximum Number of Shares that May Yet Be Repurchased Under the Plan |
|---|---|---|---|---|
| July 1 - July 31, 2016 | — | | — | — |
| August 1 - August 31, 2016 [1] | 1,294,467 | $ 14.00 | 1,294,467 | N/A |
| September 1 - September 30, 2016 [2] | 137,500 | 14.06 | 137,500 | 1,362,500 |
| | 1,431,967 | | 1,431,967 | |

[1] On August 9, 2016, the Company completed the repurchase of $18.1 million in shares through a self-tender offer, announced July 13, 2016.

[2] On September 9, 2016, the Board of Directors authorized the repurchase of up to 1,500,000 shares of the Company's common stock, or 12.5% of the Company's outstanding shares. This plan expires on March 27, 2017. For more information on this repurchase, see Note 11 - Subsequent Events - Stock Repurchase Plan in Item 1 of this report.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits and Financial Statement Schedules

(a) Exhibits

| | |
|---|---|
| 3.1 | Articles of Incorporation of First Financial Northwest [1] |
| 3.2 | Amended and Restated Bylaws of First Financial Northwest [2] |
| 4.0 | Form of stock certificate of First Financial Northwest [1] |
| 10.1 | Amended Employment Agreement between First Savings Bank Northwest and Joseph W. Kiley III [3] |
| 10.2 | Form of Change in Control Severance Agreement for Executive Officers [4] |
| 10.3 | Form of Supplemental Executive Retirement Agreement entered into by First Savings Bank with Joseph W. Kiley III [5] |
| 10.4 | 2008 Equity Incentive Plan [6] |
| 10.5 | 2016 Equity Incentive Plan [7] |
| 10.6 | Forms of incentive and non-qualified stock option award agreements [8] |
| 10.7 | Form of restricted stock award agreement [8] |
| 10.8 | Settlement Agreement and Mutual Release with the Stilwell Group [9] |
| 10.9 | Amendment No. 1 to the Settlement Agreement and Releases with the Stilwell Group [10] |
| 10.1 | Amendment No. 2 to the Settlement Agreement and Releases with the Stilwell Group [11] |
| 10.11 | Employment Agreement between First Savings Bank Northwest and Richard P. Jacobson [3] |
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act |
| 101 | The following materials from First Financial Northwest’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements. |

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[1] Filed as an exhibit to First Financial Northwest’s Registration Statement on Form S-1 (333-143539)
[2] Filed as an exhibit to First Financial Northwest’s Current Report on Form 8-K dated March 24, 2016.
[3] Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 5, 2013.
[4] Filed as an exhibit to First Financial Northwest’s Current Report on Form 8-K dated September 9, 2014.
[5] Filed as an exhibit to First Financial Northwest’s Current Report on Form 8-K dated September 12, 2016.
[6] Filed as Appendix A to First Financial Northwest’s definitive proxy statement dated April 15, 2008.
[7] Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated June 15, 2016.
[8] Filed as an exhibit to First Financial Northwest’s Current Report on Form 8-K dated July 1, 2008.
[9] Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 20, 2012.
[10] Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated January 17, 2013.
[11] Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated February 26, 2013.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FINANCIAL NORTHWEST, INC.

| | | |
|---|---|---|
| Date: November 8, 2016 | By: | /s/Joseph W. Kiley III |
| | | Joseph W. Kiley III |
| | | President and Chief Executive Officer (Principal Executive Officer) |
| Date: November 8, 2016 | By: | /s/Richard P. Jacobson |
| | | Richard P. Jacobson |
| | | Executive Vice President and Chief Financial Officer (Principal Financial Officer) |
| Date: November 8, 2016 | By: | /s/Christine A. Huestis |
| | | Christine A. Huestis |
| | | Vice President and Controller (Principal Accounting Officer) |

Exhibit Index

| Exhibit No. | Description |
| --- | --- |
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act |
| 101 | The following materials from First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements. |