FS Bancorp, Inc.
Form 10-K
March 16, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 K

(Mark one)

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

For the fiscal year ended December 31, 2017 OR

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

Commission File Number: 001 35589

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13 (a) of the Exchange Act. [ ]

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

As of March 9, 2018, there were 3,695,552 shares of the Registrant's common stock outstanding. The Registrant's common stock is listed on the NASDAQ Capital Market under the symbol "FSBW." The aggregate market value of the common stock held by non-affiliates of the Registrant was $121,778,776, based on the closing sales price of $43.77 per share of the Registrant's common stock as quoted on the NASDAQ Capital Market on June 30, 2017. For purposes of this calculation, common stock held only by executive officers and directors of the Registrant is considered to be held by affiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1.Portions of the definitive Proxy Statement for the 2018 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

FS Bancorp, Inc.

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

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Forward-Looking Statements

This Form 10 K contains forward-looking statements, which can be identified by the use of words such as "believes," "expects," "anticipates," "estimates" or similar expressions. Forward-looking statements include, but are not limited to:

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

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

- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies, write offs, changes in our allowance for loan losses, and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values in our market area;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our home lending operations, our warehouse lending, and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within the expected time frames and any goodwill charges related thereto;
- our ability to control operating costs and expenses;
- our ability to retain key members of our senior management team;
- changes in consumer spending, borrowing, and savings habits;

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- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), changes in regulation policies and principles, an increase in regulatory capital requirements or change in the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board, or the Financial Accounting Standards Board;
- costs and effects of litigation, including settlements and judgments;
- disruptions, security breaches, or other adverse events, failures or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions;
- our ability to implement our branch expansion strategy;
- inability of key third-party vendors to perform their obligations to us; and
- other economic, competitive, governmental, regulatory, and technical factors affecting our operations, pricing, products, and services, and other risks described elsewhere in this Form 10 K and our other reports filed with the U.S. Securities and Exchange Commission (“SEC”).

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

Available Information

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

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PART 1

Item 1. Business

General

FS Bancorp, Inc. ("FS Bancorp" or the "Company"), a Washington corporation, was organized in September 2011 for the purpose of becoming the holding company of 1st Security Bank of Washington ("1st Security Bank of Washington" or the "Bank") upon the Bank's conversion from a mutual to a stock savings bank ("Conversion"). The Conversion was completed on July 9, 2012. At December 31, 2017, the Company had consolidated total assets of $981.8 million, total deposits of $829.8 million, and stockholders' equity of $122.0 million. The Company has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this Annual Report on Form 10 K ("Form 10 K"), including the consolidated financial statements and related data, relates primarily to the Bank.

1st Security Bank of Washington is a relationship-driven community bank. The Bank delivers banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Bank emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Bank is also actively involved in community activities and events within these market areas, which further strengthens relationships within these markets. The Bank has been serving the Puget Sound area since 1936. Originally chartered as a credit union, and known as Washington's Credit Union, the Bank served various select employment groups. On April 1, 2004, the Bank converted from a credit union to a Washington state-chartered mutual savings bank. Upon completion of the Conversion in July 2012, 1st Security Bank of Washington became a Washington state-chartered stock savings bank and the wholly owned subsidiary of the Company.

At December 31, 2017, the Bank maintained its main administrative office, 11 full-service bank branches and seven home loan production offices in suburban communities in the greater Puget Sound area. The Bank also has one home loan production office in the Tri-Cities, Washington. On January 22, 2016, the Company completed the purchase of four retail bank branches from Bank of America (two in Clallam and two in Jefferson counties) (the "Branch Purchase"). The Branch Purchase expanded our Puget Sound-focused retail footprint onto the Olympic Peninsula and provided an opportunity to extend our unique brand of community banking into those communities. See "Item 8. Financial Statements and Supplementary Data - Notes to Consolidated Financial Statements - Note 2 Business Combinations" of this Form 10 K. In November 2016, the Bank installed a free standing automated teller machine ("ATM") in Kingston, Washington. The Company also has entered into a lease for a bank branch located in Silverdale, Washington, expected to open in April 2018.

The Company is a diversified lender with a focus on the origination of one-to-four-family loans, commercial real estate mortgage loans, indirect home improvement loans ("fixture secured loans"), consumer loans including marine lending, commercial business loans and second mortgage or home equity loan products. Historically, consumer loans, in particular fixture secured loans had represented the largest portion of the Company's loan portfolio and had traditionally been the mainstay of the Company's lending strategy. In recent years, the Company has placed more of an emphasis on real estate lending products, such as one-to-four-family loans, commercial real estate loans, including speculative residential construction loans, as well as commercial business loans, while growing the current size of the consumer loan portfolio. The Company reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale into the secondary market, through a mortgage banking program. The Company's lending strategies are intended to take advantage of: (1) the Company's historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities, and (3) relationship lending. Retail deposits will continue to serve as an important funding source. For more information regarding the business and operations of 1st Security

Bank of Washington, see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Form 10 K.

1st Security Bank of Washington is examined and regulated by the Washington State Department of Financial Institutions (“DFI”), its primary regulator, and by the Federal Deposit Insurance Corporation (“FDIC”). 1st Security Bank of Washington is required to have certain reserves set by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and is a member of the Federal Home Loan Bank of Des Moines (“FHLB” or “FHLB of Des Moines”), which is one of the 11 regional banks in the Federal Home Loan Bank System.

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

Market Area

The Company conducts operations out of its main administrative office, seven home loan production offices, and 11 full-service bank branches in the Puget Sound region of Washington, as well as one loan production office in eastern Washington. The administrative office is located in Mountlake Terrace, in Snohomish County, Washington. The four stand-alone home lending offices in the Puget Sound region are located in Puyallup, in Pierce County, Bellevue, in King County, Port Orchard, in Kitsap County, Everett, in Snohomish County, and the one stand-alone home lending office in Eastern Washington is located in Tri-Cities (Kennewick), in Benton County, Washington. Regarding the 11 full-service bank branches, three branch offices are located in Snohomish County, two branch offices are located in King County, two branch offices are located in Clallam County, two branch offices in Jefferson County, one branch office is located in Pierce County, and one in Kitsap County.

The primary market area for business operations is the Seattle-Tacoma-Bellevue, Washington Metropolitan Statistical Area (the “Seattle MSA”). Kitsap, Clallam, and Jefferson counties, though not in the Seattle MSA, are also part of the Company’s market area. This overall region is typically known as the Puget Sound region. The population of the Puget Sound region was an estimated 3.9 million in 2017, over half of the state’s population, representing a large population base for potential business. The region has a well-developed urban area in the western portion along Puget Sound, with the north, central and eastern portions containing a mixture of developed residential and commercial neighborhoods and undeveloped, rural neighborhoods.

The Puget Sound region is the largest business center in both the State of Washington and the Pacific Northwest. Currently, key elements of the economy are aerospace, military bases, clean technology, biotechnology, education, information technology, logistics, international trade and tourism. The region is well known for the long presence of The Boeing Corporation and Microsoft, two major industry leaders, and for its leadership in technology. Amazon.com has expanded significantly in the Seattle downtown area. The workforce in general is well-educated and strong in technology. Washington State’s location with regard to the Pacific Rim, along with a deepwater port has made international trade a significant part of the regional economy. Tourism has also developed into a major industry for the area, due to the scenic beauty, temperate climate and easy accessibility.

King County, the location of the city of Seattle, has the largest employment base and overall level of economic activity. Six of the largest employers in the state are headquartered in King County including Microsoft Corporation, University of Washington, Amazon.com, King County Government, Starbucks, and Swedish Health Services. Pierce County’s economy is also well diversified with the presence of military related government employment (Joint Base Lewis-McChord), along with health care (the Multicare Health System and the Franciscan Health System). In addition, there is a large employment base in the economic sectors of shipping (the Port of Tacoma) and aerospace employment (Boeing). Snohomish County to the north has an economy based on aerospace employment (Boeing), health care (Providence Regional Medical Center), and military (the Everett Naval Station) along with additional employment concentrations in biotechnology, electronics/computers, and wood products.

The United States Navy is a key element for Kitsap County’s economy. The United States Navy is the largest employer in the county, with installations at Puget Sound Naval Shipyard, Naval Undersea Warfare Center Keyport and Naval Base Kitsap (which comprises former Naval Submarine Base Bangor, and Naval Station Bremerton). The largest private employers in the county are the Harrison Medical Center and Port Madison Enterprises.

In 2015, the median household income for King County was $75,302, compared to $64,939 for the State of Washington, and $55,775 for the United States. In 2008, the U.S. Census Bureau determined that Seattle had the highest percentage of college and university graduates of any U.S. city. Seattle has been listed in the top three most literate cities in the country every year since 2005 by an annual review conducted by Central Connecticut State University.

Unemployment in Washington was an estimated 4.5% at December 31, 2017, down from a high of 10.2% in March 2010, closely paralleling national trends as disclosed in the U.S. Bureau of Labor Statistics. King County had the lowest unemployment rate in the state at 3.6%, slightly increased from 3.4% in the prior year, and much lower than the state average of 4.5% and national average of 4.1%, respectively. The estimated unemployment rate in Snohomish County at year end 2017 was 4.0%, slightly increased from 3.9% at year end 2016. Kitsap County's unemployment rate improved to 5.0% at December 31, 2017, compared to 5.5% at December 31, 2016. At December 31, 2017, the estimated unemployment rate in Pierce County was 5.4%, down from 6.0% at December 31, 2016. Outside of the Puget Sound area, the Tri-Cities market includes two counties, Benton and Franklin, and two full-service branches in Clallam County and two in Jefferson County. The estimated unemployment rate in Benton County at year end 2017 was 6.1%, down from 7.0% at year end 2016. At December 31, 2017, the estimated unemployment rate in Franklin County was down to 8.0%, from 9.5% at December 31, 2016. For Clallam and Jefferson counties, the estimated unemployment rates at December 31, 2017 decreased to 7.0% and 6.2%, respectively, compared to 8.1% and 7.4%, respectively at December 31, 2016.

According to the Washington Center for Real Estate Research, home values in the State of Washington continued to improve in 2017. For the quarter ended December 31, 2017, the average home value was $641,000 in King County, $442,000 in Snohomish County, $357,000 for Jefferson County, $316,000 in Pierce County, $320,000 in Kitsap County, $276,000 for Clallam County, and $251,000 for both Benton and Franklin counties. Compared to the statewide average increase in home values of 8.8% in the fourth quarter of 2017, Clallam, Benton and Franklin, Snohomish, Kitsap, and Pierce counties outperformed the state average, with 13.6%, 13.4%, 12.7%, 11.3%, and 10.4% increases in average home values, respectively. Although just below the state average, King county increased 8.7% in average home values year over year, and Jefferson County experienced a 1.2% increase in average home values in the fourth quarter 2017.

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

Lending Activities

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

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

	December 31,								
	2017		2016		2015		2014		2013
loans	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount
l	$ 63,611	8.22 %	$ 55,871	9.23 %	$ 50,034	9.78 %	$ 42,970	10.90 %	$ 32,970
n and nt	143,068	18.50	94,462	15.60	80,806	15.80	57,813	14.67	41,633
y	25,289	3.27	20,081	3.32	16,540	3.24	15,737	3.99	15,172
r-family	163,655	21.16	124,009	20.48	102,921	20.13	46,801	11.87	20,809
y	44,451	5.75	37,527	6.20	22,223	4.35	16,201	4.11	4,682
state	440,074	56.90	331,950	54.83	272,524	53.30	179,522	45.54	115,266
oans ne nt	130,176	16.83	107,759	17.80	103,064	20.16	99,304	25.19	91,167
	41,049	5.31	36,503	6.03	29,226	5.72	18,162	4.61	16,838
	35,397	4.58	28,549	4.71	23,851	4.66	16,713	4.24	11,203
umer	2,046	0.26	1,915	0.32	2,181	0.43	2,628	0.66	3,498
mer	208,668	26.98	174,726	28.86	158,322	30.97	136,807	34.70	122,706
l ns l and	83,306	10.77	65,841	10.88	59,619	11.66	55,624	14.11	42,657
	41,397	5.35	32,898	5.43	20,817	4.07	22,257	5.65	6,587
nercial ns	124,703	16.12	98,739	16.31	80,436	15.73	77,881	19.76	49,244
gross	773,445	100.00 %	605,415	100.00 %	511,282	100.00 %	394,210	100.00 %	287,216
for loan	(10,756)		(10,211)		(7,785)		(6,090)		(5,092)
sts, ums ts, net	(1,131)		(1,887)		(962)		(946)		(1,043)
net	$ 761,558		$ 593,317		$ 502,535		$ 387,174		$ 281,081

(1) Excludes loans held for sale.

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

	December 31, 2017		2016		2015		2014		2013
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount
ans:									
ans	$ 32,430	4.19 %	$ 30,445	5.03 %	$ 26,189	5.12 %	$ 23,144	5.87 %	$ 23,210
and	286	0.04	—	—	315	0.06	322	0.08	525
	2,649	0.34	1,644	0.27	2,146	0.42	2,677	0.68	2,664
amily d for	11,804	1.53	10,267	1.69	9,305	1.82	8,108	2.06	19,981
	14,453	1.87	4,538	0.75	2,659	0.52	3,240	0.82	3,467
ate	61,622	7.97	46,894	7.74	40,614	7.94	37,491	9.51	49,847
ans	207,671	26.85	174,041	28.75	157,805	30.87	136,368	34.59	122,346
s and	32,835	4.24	26,901	4.45	17,440	3.41	16,197	4.11	19,792
	673	0.09	—	—	—	—	—	—	—
rcial s	33,508	4.33	26,901	4.45	17,440	3.41	16,197	4.11	19,792
ate	302,801	39.15	247,836	40.94	215,859	42.22	190,056	48.21	191,985
te									
ans	31,181	4.03	25,426	4.20	23,845	4.66	19,826	5.03	9,760
and	142,782	18.46	94,462	15.60	80,491	15.74	57,491	14.58	41,108
	22,640	2.93	18,437	3.05	14,394	2.82	13,060	3.31	12,508
amily d for	151,851	19.63	113,742	18.79	93,616	18.31	38,693	9.82	828
	29,998	3.88	32,989	5.45	19,564	3.83	12,961	3.29	1,215
ate	378,452	48.93	285,056	47.09	231,910	45.36	142,031	36.03	65,419
ans	997	0.13	685	0.11	517	0.10	439	0.11	360

s and	50,471	6.53	38,940	6.43	42,178	8.25	39,427	10.00	22,865
	40,724	5.26	32,898	5.43	20,818	4.07	22,257	5.65	6,587
rcial s	91,195	11.79	71,838	11.86	62,996	12.32	61,684	15.65	29,452
te	470,644	60.85	357,579	59.06	295,423	57.78	204,154	51.79	95,231
ross	773,445	100.00 %	605,415	100.00 %	511,282	100.00 %	394,210	100.00 %	287,216
r loan	(10,756)		(10,211)		(7,785)		(6,090)		(5,092)
s, ns s, net	(1,131)		(1,887)		(962)		(946)		(1,043)
et	$ 761,558		$ 593,317		$ 502,535		$ 387,174		$ 281,081

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Loan Maturity and Repricing. The following table sets forth certain information at December 31, 2017, regarding the dollar amount and current note rates of interest for the loans maturing or repricing in the portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loan balances do not include undisbursed loan proceeds, unearned discounts, unearned income, and allowance for loan losses.

n and nt	Home Equity		One-to-Four-Family (2)		Multi-family		Consumer	
Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
6.01 %	$ 24,055	5.51 %	$ 14,214	4.72 %	$ 6,242	3.70 %	$ 1,984	10.15 %
6.00	—	—	9,686	4.17	8,340	4.45	1,556	7.39
—	16	7.00	29,859	4.25	2,814	4.41	2,988	6.74
4.40	413	6.94	43,046	4.46	6,089	4.54	10,255	7.96
4.39	33	7.75	61,755	3.91	18,554	4.44	51,867	7.75
6.00	—	—	1,718	4.33	2,275	4.94	112,255	6.29
6.09	772	6.27	3,377	4.51	137	5.44	27,763	6.16
5.97 %	$ 25,289	5.56 %	$ 163,655	4.22 %	$ 44,451	4.38 %	$ 208,668	6.77 %

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

The total amount of loans due after December 31, 2018, which have predetermined interest rates is $284.2 million, while the total amount of loans due after this date which have floating or adjustable interest rates is $235.7 million.

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

The Board of Directors has implemented a lending limit policy that it believes matches the Washington State legal lending limit. At December 31, 2017, the Company's policy limits loans to one borrower and the borrower's related entities to 20% of the Bank's unimpaired capital and surplus, or $27.5 million at December 31, 2017. Management has adopted an internal lending limit of a maximum of 80% of the Bank's legal lending limit for risk mitigation purposes and all loans over this limit require approval from the AQC. The Bank's largest lending relationship at December 31, 2017, consisted of a commercial line of credit to one company having a commitment of $21.0 million. This line of credit is secured by notes to finance residential construction projects located primarily in Seattle, Washington. The outstanding balance of this line of credit at December 31, 2017 was $13.0 million. The second largest lending relationship consisted of seven residential construction loans having combined commitments of $16.2 million to two related limited liability companies. All of these loans are secured by residential construction loan projects located in the Seattle metropolitan area of Washington State. The outstanding balance of these seven loans at December 31, 2017 was $7.3 million. The third largest lending relationship consisted of two commercial lines of credit having combined commitments of $15.7 million, to two related limited liability companies. Both of these loans are secured by residential construction projects located primarily in Seattle, Washington. The outstanding balance of these two lines of credit at December 31, 2017 was $854,000. All of the loans listed above were performing in accordance with their repayment terms at December 31, 2017.

At December 31, 2017, the Company had $35.0 million approved in mortgage warehouse lending lines for six companies. The commitments ranged from $3.0 million to $9.0 million. At December 31, 2017, there was $7.4 million in mortgage warehouse lines outstanding, compared to $35.0 million approved in mortgage warehouse lending lines with $7.8 million outstanding at December 31, 2016. In addition, the Company had $84.7 million in approved commercial construction warehouse lending lines for nine companies. The commitments range from $5.0 million to $21.0 million. At December 31, 2017, there was $34.0 million outstanding, compared to $49.0 million approved in commercial construction warehouse lending lines for eight companies with $25.1 million outstanding at December 31, 2016.

Commercial Real Estate Lending. The Company offers a variety of commercial real estate loans. Most of these loans are secured by income producing properties, including multi-family residences, retail centers, warehouses and office buildings located in the market areas. At December 31, 2017, commercial real estate loans (including $44.5 million of multi-family residential loans) totaled $108.1 million, or 14.0%, of the gross loan portfolio.

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

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

Loans secured by commercial real estate properties generally involve a greater degree of credit risk than one-to-four-family residential mortgage loans. These loans typically involve large balances to single borrowers or groups of related borrowers. Because payments on loans secured by commercial and multi-family real estate properties are often

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dependent on the successful operation or management of the properties, repayment of these loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower’s ability to repay the loan may be impaired. Commercial and multi-family loans also expose a lender to greater credit risk than loans secured by one-to-four-family because the collateral securing these loans typically cannot be sold as easily as one-to-four-family. In addition, most of our commercial and multi-family loans are not fully amortizing and include balloon payments upon maturity. Balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. The largest single commercial real estate loan at December 31, 2017 was a 50% participation loan originated by another bank in the Puget Sound area. The Bank’s share of the total outstanding loan at December 31, 2017 was $5.0 million, and is collateralized by commercial real estate located in King County, Washington. At December 31, 2017 this loan was performing in accordance with its repayment terms.

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

Construction and Development Lending. The Company expanded its residential construction lending team in 2011 with a focus on vertical, in-city one-to-four-family development in our market area. This team has over 60 years of combined experience and expertise in acquisition, development and construction (“ADC”) lending in the Puget Sound market area. The Company has implemented this strategy to take advantage of what is believed to be a strong demand for construction and ADC loans to experienced, successful and relationship driven builders in our market area after many other banks abandoned this segment because of previous overexposure. At December 31, 2017, outstanding construction and development loans totaled $143.1 million, or 18.5%, of the gross loan portfolio and consisted of 188 projects, compared to $94.5 million and 164 projects at December 31, 2016. The construction and development loans at December 31, 2017, consisted of loans for residential and commercial construction projects primarily for vertical construction and $11.5 million of land acquisition and development loans. Total committed, including unfunded construction and development loans at December 31, 2017, was $222.0 million. At December 31, 2017, $80.0 million, or 55.9% of our outstanding construction and development loan portfolio was comprised of speculative one-to-four-family construction loans. In addition, the Company had nine commercial secured lines of credit, secured by notes to residential construction borrowers with guarantees from principles with experience in the construction RE-lending market. These loans had combined commitments of $84.7 million, and an outstanding balance of $34.0 million at December 31, 2017.

The Company’s residential construction lending program totaled $120.3 million at December 31, 2017. This amount includes loans for the purpose of constructing both speculative and pre-sold one-to-four-family residences, the acquisition of in-city lots with and without existing improvements for later development of one-to-four-family residences, the acquisition of land to be developed, and loans for the acquisition and development of land for future development of single family residences. The Company generally limits these types of loans to known builders and developers in the market area. Construction loans generally provide for the payment of interest only during the construction phase, which is typically up to 12 months. At the end of the construction phase, the construction loan is generally paid off through the sale of the newly constructed home and a permanent loan from another lender, although commitments to convert to a permanent loan may be made by us. Construction loans are generally made with a maximum loan amount of the lower of 95% of cost or 75% of appraised value at completion. During the term of construction, the accumulated interest on the loan is typically added to the principal balance of the loan through an interest reserve of 3% to 5.5% of the loan commitment amount.

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

The Company may also make land acquisition and development loans to builders or residential lot developers on a limited basis. These loans involve a higher degree of credit risk, similar to commercial construction loans. At December 31, 2017, included in the $143.1 million of construction and development loans, were seven residential land acquisition and development loans for finished lots totaling $9.4 million, with total commitments of $13.1 million. These land loans also involve additional risks because the loan amount is based on the projected value of the lots after development. Loans are made for up to 75% of the estimated value with a term of up to two years. These loans are required to be paid on an accelerated basis as the lots are sold, so that the Company is repaid before all the lots are sold. Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate.

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

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

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

Home Equity Lending. The Company has been active in second mortgage and home equity lending, with the focus of this lending being conducted in the Company's primary market area. The home equity lines of credit generally have adjustable rates tied to the prime rate of interest with a draw term of ten years plus and a term to maturity of 15 years. Monthly payments are based on 1.0% of the outstanding balance with a maximum combined loan-to-value ratio of up to 90%, including any underlying first mortgage. Second mortgage home equity loans are typically fixed rate, amortizing loans with terms of up to 15 years. Total second mortgage/home equity loans totaled $25.3 million, or 3.3% of the gross loan portfolio, at December 31, 2017, $22.6 million of which were adjustable rate home equity lines of credit. Unfunded commitments on home equity lines of credit at December 31, 2017, was $32.9 million.

Residential. The Company originates loans secured by first mortgages on one-to-four-family residences primarily in the market area. The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders, and from existing customers. Retail banking customers are also an important source of the Company’s loan originations. The Company originated $812.1 million of one-to-four-family consumer mortgages (including $8.4 million loans brokered to other institutions) and sold $718.0 million to investors in 2017. Of the loans sold to investors, $443.2 million were sold to the Federal National Mortgage Association (“Fannie Mae”), Government National Mortgage Association (“Ginnie Mae”), FHLB, and/or Federal Home Loan Mortgage Corporation (“Freddie Mac”) with servicing rights retained in order to further build the relationship with the customer. At December 31, 2017, one-to-four-family residential mortgage loans totaled $163.7 million, or 21.2%, of the gross loan portfolio, excluding loans held for sale of $53.5 million. In addition, the Company originated $10.3 million in residential loans through our commercial lending channel, secured by single family rental homes in Washington, with combined commitments of $10.3 million, and an outstanding balance of $7.9 million at December 31, 2017, classified as commercial business loans that are not included in our one-to-four-family residential mortgage loan portfolio. See “Commercial Business Lending.”

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

Consumer Lending. Consumer lending represents a significant and important historical activity for the Company, primarily reflecting the indirect lending through home improvement contractors and dealers. At December 31, 2017, consumer loans totaled $208.7 million, or 27.0% of the gross loan portfolio.

The Company’s indirect home improvement loans, also referred to as fixture secured loans, represent the largest portion of the consumer loan portfolio and have traditionally been the mainstay of the Company’s lending strategy. These loans totaled $130.2 million, or 16.8% of the gross loan portfolio, and 62.4% of total consumer loans, at December 31, 2017. Indirect home improvement loans are originated through a network of 88 home improvement contractors and dealers located in Washington, Oregon, California, Idaho, and newly introduced in Colorado. Six dealers are responsible for a majority, or 56.7% of the loan volume. These fixture secured loans consist of loans for a wide variety of products, such as replacement windows, siding, roofs, HVAC systems, and roofing materials.

Solar loans are the second largest portion of the consumer loan portfolio which totaled $41.0 million, or 5.3% of the gross loan portfolio. At December 31, 2017, the Company had $40.8 million in solar loans to borrowers that reside in California, or 99.4% of total solar loans, and 19.6% of total consumer loans. The Company will continue to originate solar loans throughout its geographic footprint with an emphasis on the California market.

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

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

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failure to perfect a security interest risks avoidance of the security interest in bankruptcy or subordination to the claims of third parties.

The Company also offers consumer marine loans secured by boats. Marine loans represent the third largest segment of the consumer loan portfolio. At December 31, 2017, the marine loan portfolio totaled $35.4 million, or 4.6% of the gross loan portfolio and 17.0% of total consumer loans. Marine loans are originated with borrowers on both a direct and indirect basis, and generally carry terms of up to 20 years with fixed rates of interest. The Company generally requires a 10% down payment, and the loan amount may be up to the lesser of 120% of factory invoice or 90% of the purchase price.

The Company originates other consumer loans which totaled $2.1 million at December 31, 2017. These loans primarily include personal lines of credit, automobile, direct home improvement, loans on deposit, and recreational loans.

In evaluating any consumer loan application, a borrower's FICO score is utilized as an important indicator of credit risk. The FICO score represents the creditworthiness of a borrower based on the borrower's credit history, as reported by an independent third party. A higher FICO score typically indicates a greater degree of creditworthiness. Over the last several years the Company has emphasized originations of loans to consumers with higher credit scores. This has resulted in a lower level of loan charge-offs in recent periods. At December 31, 2017, 70.4% of the consumer loan portfolio was originated with borrowers having a FICO score over 720 at the time of origination, and 25.6% was originated with borrowers having a FICO score between 660 and 720 at the time of origination. Generally, a FICO score of 660 or higher indicates the borrower has an acceptable credit reputation. A credit score at the time of loan origination of less than 660 is considered "subprime" by federal banking regulators and comprised just 4.0% of our consumer loan portfolio. Borrowers of our one-to-four-family loans had an average FICO score of 728 at the time of loan origination. Consideration for loans with FICO scores below 660 require additional management oversight and approval.

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

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

Commercial Business Lending. The Company originates commercial business loans and lines of credit to local small- and mid-sized businesses in the Puget Sound market area that are secured by accounts receivable, inventory or property, plant and equipment. Consistent with management's objectives to expand commercial business lending, in 2009, the Company commenced a mortgage warehouse lending program through which the Company funds third-party residential mortgage bankers. Under this program the Company provides short term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. The Company's warehouse lending lines are secured by the underlying notes associated with one-to-four-family mortgage loans made to borrowers by the mortgage banking company and generally require guarantees from the principal shareholder(s) of the mortgage banking company. These loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down the outstanding loan before being dispersed to the mortgage bank.

The Company also has commercial construction warehouse lines secured by notes on construction loans and typically guaranteed by principles with experience in construction lending. In April 2013, we commenced an expansion of our mortgage warehouse lending program to include construction "RE-Lending" warehouse lines. These lines are secured by notes provided to construction lenders and are typically guaranteed by a principle of the borrower. Terms for the underlying notes can be up to 18 months and the Bank will lend a percentage (typically 75%) of the underlying note which may have a loan-to-value ratio up to 75%. Combined, the loan-to-value ratio on the underlying note would be up to 52.5% with additional credit support provided by the guarantor.

At December 31, 2017, the Company had $35.0 million approved in residential mortgage warehouse lending lines for six companies. The commitments ranged from $3.0 million to $9.0 million. At December 31, 2017, there was $7.4 million in residential warehouse lines outstanding, compared to $35.0 million in approved residential warehouse lending lines with $7.8 million outstanding at December 31, 2016. In addition, the Company had $84.7 million in approved commercial construction warehouse lending lines for nine companies. The commitments range from $5.0 million to $21.0 million. At December 31, 2017, there was $34.0 million outstanding, compared to $49.0 million approved in commercial warehouse lending lines for eight companies with $25.1 million outstanding at December 31, 2016.

Commercial business loans may be fixed-rate, but are usually adjustable-rate loans indexed to the prime rate of interest, plus a margin. Some of the commercial business loans, such as those made pursuant to the warehouse lending program, are structured as lines of credit with terms of 12 months and interest only payments required during the term, while other loans may reprice on an annual basis and amortize over a two to five year period. Due to the current interest rate environment, these loans and lines of credit are generally originated with a floor, which set between 2.0% and 7.0%. Loan fees are generally charged at origination depending on the credit quality and account relationships of the borrower. Advance rates on these types of lines are generally limited to 80% of accounts receivable and 50% of inventory. The Company also generally requires the borrower to establish a deposit relationship as part of the loan approval process. At December 31, 2017, the commercial business loan portfolio totaled $124.7 million, or 16.1%, of the gross loan portfolio including warehouse lending loans.

At December 31, 2017, most of the commercial business loans were secured. The Company's commercial business lending policy includes credit file documentation and analysis of the borrower's background, capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as an evaluation of other conditions affecting the borrower. Analysis of the borrower's past, present and future cash flows is also an important aspect of credit analysis. The Company generally requires personal guarantees on commercial business loans. Nonetheless, commercial business loans are believed to carry higher credit risk than residential mortgage loans. The two largest commercial business lending relationships consisted of one line of credit to one company, and two lines of credit to two related limited liability companies. The first line of credit loan or lending relationship at December 31, 2017 consisted of a commercial line of credit having a commitment of $21.0 million. This line of credit is secured by residential construction projects located primarily in Seattle, Washington. The outstanding balance of this line of credit at December 31, 2017 was $13.0 million. The second of the two largest commercial business lending relationships consisted of two commercial lines of credit having combined commitments of $15.7 million. Both of these lines of credit are secured by residential construction projects located primarily in Seattle, Washington. The outstanding balance of these two lines of credit at December 31, 2017 was $854,000.

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

Loan Originations, Servicing, Purchases and Sales

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

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

The Company will sell long-term, fixed-rate residential real estate loans in the secondary market to mitigate interest rate risk. These loans are generally sold for cash in amounts equal to the unpaid principal amount of the loans determined using present value yields to the buyer. Some residential real estate loans originated as Federal Housing Administration or FHA, U.S. Department of Veterans Affairs or VA, or United States Department of Agriculture or USDA Rural Housing loans were sold by the Company as servicing released loans to other companies. A majority of residential real estate loans sold by the Company were sold with servicing retained at a specified servicing fee. The Company earned gross mortgage servicing fees of $2.2 million for the year ended December 31, 2017. During the second quarter of 2017, the Company sold $564.8 million of the mortgage servicing assets (“MSA”) with a mortgage servicing rights (“MSRs”) book value of $4.8 million and generated an associated gain of $1.1 million. At December 31, 2017, the Company was servicing $775.8 million of one-to-four-family loans for Fannie Mae, Freddie Mac, Ginnie Mae, FHLB, and another financial institution. These MSRs constituted a $6.8 million asset on the books on that date, which is amortized in proportion to and over the period of the net servicing income. These MSRs are periodically evaluated for impairment based on their fair value, which takes into account the rates and potential prepayments of those sold loans being serviced. The fair value of the servicing rights at December 31, 2017 was $8.6 million. See Notes 5 and 15 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

The following table presents the activity during the year ended December 31, 2017, related to loans serviced for others.

	(In thousands)
Beginning balance at January 1, 2017	
One-to-four-family	$ 973,541
Consumer	1,628
Commercial business	1,949
Subtotal	977,118
Additions	
One-to-four-family	462,559
Sales	
One-to-four-family	(564,505)
Repayments	
One-to-four-family	(95,830)
Consumer	(445)
Commercial business	(35)
Subtotal	(96,310)
Ending balance at December 31, 2017	
One-to-four-family	775,765
Consumer	1,183
Commercial business	1,914

Total	$ 778,862

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

	Year Ended December 31,	
(In thousands)	2017	2016
Originations by type:		
Fixed-rate:		
Commercial	$ 6,909	$ 9,812
Home equity	4,478	2,504
One-to-four-family (1)	4,177	3,990
Loans held for sale (one-to-four-family)	686,887	704,366
Multi-family	7,991	2,061
Consumer	107,855	84,039
Commercial business(2)	6,177	21,830
Total fixed-rate	824,474	828,602
Adjustable- rate:		
Commercial	7,107	10,224
Construction and development	123,323	73,730
Home equity	13,758	12,793
One-to-four-family (1)	96,925	51,136
Loans held for sale (one-to-four-family)	11,617	14,498
Multi-family	2,686	15,209
Consumer	2,806	1,484
Commercial business(2)	181,168	104,073
Warehouse lines, net	(428)	2,416
Total adjustable-rate	438,962	285,563
Total loans originated	1,263,436	1,114,165
Purchases by type:		
Fixed-rate:		
Commercial business(2) (3)	9,450	—
Adjustable-rate:		
Commercial	4,593	—
One-to-four-family (1)	1,100	—
Multi-family	4,250	—
Commercial business(2) (3)	19,557	—
Total loans purchased	38,950	—
Sales and repayments:		
Construction and development	(449)	(111)
One-to-four-family (1)	(20,165)	—
Loans held for sale (one-to-four-family) and commercial business(2)	(700,450)	(711,698)
Commercial business(2)	(4,008)	—
Total loans sold	(725,072)	(711,809)
Total principal repayments	(408,374)	(300,595)
Total reductions	(1,133,446)	(1,012,404)
Net increase	$ 168,940	$ 101,761

(1) One-to-four-family portfolio loans.
(2) Excludes warehouse lines.
(3) Includes USDA/U.S. Small Business Administration or SBA guaranteed loans purchased at a premium.

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

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

Asset Quality

When a borrower fails to make a required payment on a residential real estate loan, the Company attempts to cure the delinquency by contacting the borrower. In the case of loans secured by residential real estate, a late notice typically is sent 16 days after the due date, and the borrower is contacted by phone within 16 to 25 days after the due date. When the loan is 30 days past due, an action plan is formulated for the credit under the direction of the Loan Control department manager. Generally, a delinquency letter is mailed to the borrower. All delinquent accounts are reviewed by a loan control representative who attempts to cure the delinquency by contacting the borrower once the loan is 30 days past due. If the account becomes 60 days delinquent and an acceptable repayment plan has not been agreed upon, a Loan Control representative will generally refer the account to legal counsel with instructions to prepare a notice of intent to foreclose. The notice of intent to foreclose allows the borrower up to 30 days to bring the account current. Between 90 - 120 days past due, a value is obtained for the loan collateral. At that time, a mortgage analysis is completed to determine the loan-to-value ratio and any collateral deficiency. If foreclosed, the Company customarily takes title to the property and sells it directly through a real estate broker.

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

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

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The following table shows delinquent loans by the type of loan and number of days delinquent at December 31, 2017. Categories not included in the table below did not have any delinquent loans at December 31, 2017.

	Loans Delinquent For:								
	60-89 Days			90 Days or More			Total Loans Delinquent 60 Days or More		
lars in thousands)	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category	Number	Amount	Percent o Loan Category
estate loans									
e equity	—	$ —	— %	3	$ 136	0.54 %	3	$ 136	0.54
l real estate loans	—	—	—	3	136	0.03	3	136	0.03
sumer loans									
ect home ovement	20	215	0.16	12	99	0.08	32	314	0.24
r	2	19	0.05	—	—	—	2	19	0.05
l consumer loans	22	234	0.11	12	99	0.05	34	333	0.16
mercial business s									
mercial and strial	1	551	0.66	—	—	—	1	551	0.66
l commercial ness loans	1	551	0.44	—	—	—	1	551	0.44
l	23	$ 785	0.10 %	15	$ 235	0.03 %	38	$ 1,020	0.13

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

	December 31,				
(Dollars in thousands)	2017	2016	2015	2014	2013
Non-accruing loans:					
Real estate loans					
Commercial	$ —	$ —	$ —	$ —	$ 567
Home equity	151	210	47	61	172
One-to-four-family	142	—	525	73	104
Total real estate loans	293	210	572	134	843
Consumer loans					
Indirect home improvement	195	435	408	250	258
Solar	—	69	37	29	—
Marine	—	—	—	19	—
Other consumer	—	7	—	1	—
Total consumer loans	195	511	445	299	258
Commercial business loans					
Commercial and industrial	551	—	—	—	—
Total commercial business loans	551	—	—	—	—
Total non-accruing loans	1,039	721	1,017	433	1,101

Accruing loans contractually past due 90 days or more	—	—	—	—	—
Real estate owned	—	—	—	—	2,075
Repossessed consumer property	—	15	—	—	32
Total non-performing assets	$ 1,039	$ 736	$ 1,017	$ 433	$ 3,208
Restructured loans	$ 55	$ 57	$ 734	$ 783	$ 815
Total non-performing assets as a percentage of total assets	0.11 %	0.09 %	0.15 %	0.08 %	0.77 %

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For the year ended December 31, 2017, gross interest income which would have been recorded had the non-accruing loans been current in accordance with their original terms was $16,000. Prior to non-accrual status, the amount of interest income included in net income for the year ended December 31, 2017 was $44,000 for these loans.

Real Estate Owned. Real estate acquired by the Company as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate owned until it is sold. When the property is acquired, it is recorded at the lower of its cost, which is the unpaid principal balance of the related loan plus foreclosure costs, or the fair market value of the property less selling costs. The Company had no real estate owned properties as of December 31, 2017.

Restructured Loans. According to generally accepted accounting principles in the United States of America ("U.S. GAAP"), the Company is required to account for certain loan modifications or restructuring as a "troubled debt restructuring." In general, the modification or restructuring of a debt is considered a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrowers that would not otherwise be considered. The Company had one restructured loan at December 31, 2017, of $55,000 that was performing in accordance with its modified terms.

Other Assets Especially Mentioned. At December 31, 2017, there was $2.0 million of loans with respect to which known information about the possible credit problems of the borrowers caused management to have doubts as to the ability of the borrowers to comply with present loan repayment terms and which may result in the future inclusion of such items in the non-performing asset categories.

Classified Assets. Federal regulations provide for the classification of lower quality loans and other assets (such as other real estate owned and repossessed property), debt and equity securities, as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and pay capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions, and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

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

In connection with the filing of periodic reports with the FDIC and in accordance with the Company's classification of assets policy, the Company regularly reviews the problem assets in the portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of the review of the Company's assets, at December 31, 2017, the Company had classified $6.5 million of assets as substandard. The $6.5 million of classified assets represented 5.3% of equity and 0.7% of total assets at December 31, 2017. The Company had $2.0 million assets classified as special mention at December 31, 2017, not included in classified assets reported above.

Allowance for Loan Losses

The Company maintains an allowance for loan losses to absorb probable incurred credit losses in the loan portfolio. The allowance is based on ongoing, monthly assessments of the estimated probable incurred losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers the types of loans and the amount of loans in the loan portfolio, peer group information, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. Large groups

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of smaller balance homogeneous loans, such as residential real estate, small commercial real estate, home equity and consumer loans, are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions. More complex loans, such as commercial real estate loans and commercial business loans, are evaluated individually for impairment, primarily through the evaluation of net operating income and available cash flow and their possible impact on collateral values.

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

The provision for loan losses was $750,000 for the year ended December 31, 2017. The allowance for loan losses was $10.8 million, or 1.4% of gross loans receivable at December 31, 2017, as compared to $10.2 million, or 1.7% of gross loans receivable outstanding at December 31, 2016. The level of the allowance is based on estimates, and the ultimate losses may vary from the estimates. Management will continue to review the adequacy of the allowance for loan losses and make adjustments to the provision for loan losses based on loan growth, economic conditions, charge-offs and portfolio composition.

Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, reflects probable incurred loan losses in the loan portfolio. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Comparison of Results of Operations for the Years Ended December 31, 2017 and 2016 - Provision for Loan Losses” and Notes 1 and 4 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

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

2016				2015				2014			
Allowance for loan losses by loan category	Loan balance	Percent of loan balance in each category to total loans		Allowance for loan losses by loan category	Loan balance	Percent of loan balance in each category to total loans		Allowance for loan losses by loan category	Loan balance	Percent of loan balance in each category to total loans	
$ 868	$ 55,871	9.23	%	$ 708	$ 50,034	9.78	%	$ 514	$ 42,970	10.90	%
2,146	94,462	15.60		1,273	80,806	15.80		1,157	57,813	14.67	
263	20,081	3.32		244	16,540	3.24		222	15,737	3.99	
1,004	124,009	20.48		947	102,921	20.13		770	46,801	11.87	
489	37,527	6.20		375	22,223	4.35		211	16,201	4.11	
4,770	331,950	54.83		3,547	272,524	53.30		2,874	179,522	45.54	
1,807	107,759	17.80		1,404	103,064	20.16		1,157	99,304	25.19	
567	36,503	6.03		407	29,226	5.72		299	18,162	4.61	
405	28,549	4.71		229	23,851	4.66		192	16,713	4.24	
35	1,915	0.32		42	2,181	0.43		33	2,628	0.66	
2,814	174,726	28.86		2,082	158,322	30.97		1,681	136,807	34.70	
1,531	65,841	10.88		2,297	59,619	11.66		1,035	55,624	14.11	
483	32,898	5.43		378	20,817	4.07		361	22,257	5.65	
2,014	98,739	16.31		2,675	80,436	15.73		1,396	77,881	19.76	
1,158	—	—		1,907	—	—		1,834	—	—	
$ 10,756	$ 605,415	100.00	%	$ 10,211	$ 511,282	100.00	%	$ 7,785	$ 394,210	100.00	%

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

	Year Ended December 31,				
(Dollars in thousands)	2017	2016	2015	2014	2013
Balance at beginning of year	$ 10,211	$ 7,785	$ 6,090	$ 5,092	$ 4,698
Charge-offs:					
Real estate loans					
Commercial	—	—	191	120	340
Construction and development	—	—	—	—	194
Home equity	65	65	57	94	257
One-to-four-family	—	—	—	—	18
Total real estate loans	65	65	248	214	809
Consumer loans					
Indirect home improvement	652	822	1,265	1,341	1,562
Solar	129	50	92	—	—
Marine	23	81	63	15	43
Other consumer	28	49	46	51	152
Total consumer loans	832	1,002	1,466	1,407	1,757
Commercial business loans					
Commercial and industrial	33	—	40	75	63
Total commercial business loans	33	—	40	75	63
Total charge-offs	930	1,067	1,754	1,696	2,629
Recoveries:					
Real estate loans					
Commercial	—	—	191	—	38
Home equity	35	68	33	80	35
One-to-four-family	—	48	—	104	18
Total real estate loans	35	116	224	184	91
Consumer loans					
Indirect home improvement	610	780	870	630	510
Solar	1	—	—	—	—
Marine	27	29	33	13	17
Other consumer	42	81	56	65	219
Total consumer loans	680	890	959	708	746
Commercial business loans					
Commercial and industrial	10	87	16	2	16
Total commercial business loans	10	87	16	2	16
Total recoveries	725	1,093	1,199	894	853
Net charge-offs (recoveries)	205	(26)	555	802	1,776
Additions charged to operations	750	2,400	2,250	1,800	2,170
Balance at end of year	$ 10,756	$ 10,211	$ 7,785	$ 6,090	$ 5,092
Net charge-offs to average loans outstanding	0.03 %	— %	0.11 %	0.24 %	0.63 %
Net charge-offs (recoveries) to average non-performing assets	23.10 %	(3.00) %	76.55 %	44.04 %	48.84 %
Allowance as a percentage of non-performing loans	1,035.23 %	1,416.23 %	765.49 %	1,406.47 %	462.49 %

Allowance as a percentage of gross loans receivable (end of year)	1.39	%	1.69	%	1.52	%	1.54	%	1.77	%

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

Investment Activities

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

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

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

As a member of the FHLB of Des Moines, the Bank had $2.9 million in stock at December 31, 2017. For the year ended December 31, 2017, the Bank received $112,000 in dividends.

The table below sets forth information regarding the composition of the securities portfolio and other investments at the dates indicated. At December 31, 2017, the securities portfolio did not contain securities of any issuer with an aggregate book value in excess of 10% of equity capital, excluding those issued by the United States Government or its agencies.

	December 31,					
	2017		2016		2015	
(In thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available-for-sale						
U.S. agency securities	$ 9,077	$ 9,115	$ 8,150	$ 8,068	$ 6,134	$ 6,035
Corporate securities	7,113	7,026	7,654	7,500	3,495	3,433
Municipal bonds	12,720	12,786	15,183	15,264	18,531	18,891
Mortgage-backed securities	40,161	39,734	45,856	45,195	22,926	22,835
U.S. Small Business Administration securities	14,014	13,819	5,862	5,848	4,011	4,023
Total securities available-for-sale	$ 83,085	$ 82,480	$ 82,705	$ 81,875	$ 55,097	$ 55,217

The composition and contractual maturities of the investment portfolio at December 31 2017, excluding FHLB stock, are indicated in the following table. The yields on municipal bonds have not been computed on a tax equivalent basis.

	Over 1 year to 5 years			Over 5 to 10 years			Over 10 years			Total Securities			
ars in ands)	Amortized Cost	Weighted Average Yield		Amortized Cost	Weighted Average Yield		Amortized Cost	Weighted Average Yield		Amortized Cost	Weighted Average Yield		Fair Valu
rities able-for-sale													
agency ities	$ —	—	%	$ 4,079	2.87	%	$ 4,998	2.86	%	$ 9,077	2.86	%	$ 9,
orate ities	5,117	2.28		1,996	2.14		—	—		7,113	2.24		7,
cipal bonds	2,001	2.61		4,111	2.92		6,608	2.72		12,720	2.77		12
gage-backed ities	1,010	2.08		9,319	2.76		29,832	2.42		40,161	2.49		39
Small ness nistration ities	—	—		12,065	2.57		1,949	2.78		14,014	2.60		13
securities able-for-sale	$ 8,128	2.34	%	$ 31,570	2.69	%	$ 43,387	2.53	%	$ 83,085	2.57	%	$ 82

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Deposit Activities and Other Sources of Funds

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

The Company's deposit composition reflects a mixture with certificates of deposit accounting for 26.8% of the total deposits at December 31, 2017, and interest and noninterest-bearing checking, savings and money market accounts comprising the balance of total deposits. The Company relies on marketing activities, convenience, customer service and the availability of a broad range of deposit products and services to attract and retain customer deposits. The Company also had $65.8 million of brokered deposits, or 7.9% of total deposits at December 31, 2017, with original terms averaging four years which were used to manage interest rate risk.

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

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

	Year Ended December 31,		
(Dollars in thousands)	2017	2016	2015
Beginning balance	$ 712,593	$ 485,178	$ 420,444
Net deposits before interest credited	113,329 (1)	224,161	61,505
Interest credited	3,920	3,254	3,229
Ending balance	$ 829,842	$ 712,593	$ 485,178
Net increase in deposits	$ 117,249	$ 227,415	$ 64,734
Percent increase	16.45 %	46.87 %	15.40 %

(1) On January 22, 2016, the Company completed the Branch Purchase from Bank of America, N.A and acquired approximately $186.4 million in deposits. At December 31, 2017, approximately $134.6 million of the acquired deposits remained with the Bank. These branches attracted new deposits with an aggregated total of $224.7 million, including public funds, for the year ended December 31, 2017.

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

	December 31, 2017		2016	
(Dollars in thousands)	Amount	Percent of Total	Amount	Percent of Total
Transactions and Savings Deposits				
Noninterest-bearing checking	$ 177,739	21.42 %	$ 145,377	20.40 %
Interest-bearing checking	119,872	14.45	63,978	8.98
Savings	72,082	8.69	54,996	7.71
Money market	228,742	27.56	242,849	34.08
Escrow accounts related to mortgages serviced	9,151	1.10	9,676	1.36
Total transaction and savings deposits	607,586	73.22	516,876	72.53
Certificates				
0.00 - 1.99%	207,485	25.00	192,665	27.04
2.00 - 3.99%	14,701	1.77	2,973	0.42
8.00	70	0.01	79	0.01
Total certificates	222,256	26.78	195,717	27.47
Total deposits	$ 829,842	100.00 %	$ 712,593	100.00 %

The following table sets forth the rate and maturity information of time deposit certificates at December 31, 2017.

	Rate				
(Dollars in thousands)	0.00 - 1.99%	2.00 - 3.99%	8.00%	Total	Percent of Total
Certificate accounts maturing in quarter ending:					
March 31, 2018	$ 57,725	$ 7	$ —	$ 57,732	25.97 %
June 30, 2018	17,468	—	—	$ 17,468	7.86
September 30, 2018	16,266	462	—	$ 16,728	7.53
December 31, 2018	16,144	—	70	$ 16,214	7.30
March 31, 2019	10,275	—	—	$ 10,275	4.62
June 30, 2019	9,031	—	—	$ 9,031	4.06
September 30, 2019	21,738	—	—	$ 21,738	9.78
December 31, 2019	14,985	18	—	$ 15,003	6.75
March 31, 2020	12,095	46	—	$ 12,141	5.46
June 30, 2020	3,839	—	—	$ 3,839	1.73
September 30, 2020	6,510	51	—	$ 6,561	2.95
December 31, 2020	1,240	—	—	$ 1,240	0.56
Thereafter	20,169	14,117	—	$ 34,286	15.43
Total	$ 207,485	$ 14,701	$ 70	$ 222,256	100.00 %
Percent of total	93.35 %	6.62 %	0.03 %	100.00 %	

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The following table indicates the amount of jumbo certificates of deposit by time remaining until maturity at December 31, 2017. Jumbo certificates of deposit are certificates in amounts of $100,000 or more.

	Maturity				
(In thousands)	3 Months or Less	Over 3 to 6 Months	Over 6 to 12 Months	Over 12 Months	Total
Certificates of deposit of less than $100,000(1)	$ 39,648	$ 7,017	$ 13,329	$ 51,495	$ 111,489
Certificates of deposit of $100,000 through $250,000	16,508	8,929	11,041	41,456	77,934
Certificates of deposit of $250,000 and over	1,576	1,522	8,572	21,163	32,833
Total certificates of deposit	$ 57,732	$ 17,468	$ 32,942	$ 114,114	$ 222,256

(1) Includes $59.3 million of brokered deposits as of December 31, 2017.

The Federal Reserve requires the Bank to maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the Federal Reserve Bank of San Francisco ("Federal Reserve Bank"). Negotiable order of withdrawal ("NOW") accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to the reserve requirements, as are any non-personal time deposits at a savings bank. As of December 31, 2017, the Bank's deposit with the Federal Reserve Bank and vault cash exceeded the reserve requirements.

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

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

As a member of the FHLB of Des Moines, the Bank is required to own capital stock in the FHLB of Des Moines and authorized to apply for advances on the security of that stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the U.S. Government) provided certain creditworthiness standards have been met. Advances are individually made under various terms pursuant to several different credit programs, each with its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. The Bank maintains a committed credit facility with the FHLB of Des Moines that provides for immediately available advances up to an aggregate of $209.7 million at December 31, 2017. At December 31, 2017, outstanding advances from the FHLB of Des Moines totaled $7.5 million.

At December 31, 2017, the Bank had no outstanding borrowings and $99.1 million additional short-term borrowing capacity with the Federal Reserve Bank. The Bank also had an aggregate of $43.0 million in unsecured Fed Funds lines of credit with other large financial institutions of which none was outstanding at December 31, 2017.

On October 15, 2015 (the “Closing Date”), FS Bancorp, Inc. closed on a third-party loan commitment by the issuance of an unsecured subordinated term note in the aggregate principal amount of $10.0 million due October 1, 2025 (the “Subordinated Note”). The Subordinated Note bears interest at an annual interest rate of 6.50%, payable by the Company quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, commencing on the first such date following the Closing Date and on the maturity date. The Subordinated Note will mature on October 1, 2025 but may be prepaid at the Company’s option and with regulatory approval at any time on or after five years after the Closing Date or at any time upon certain events, such as a change in the regulatory capital treatment of the Subordinated Note or the interest on the Subordinated Note no longer being deductible by the Company for United States federal income tax purposes. The Company contributed $9.0 million of the proceeds from the Subordinated Note as additional capital to the Bank in the

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

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

	Year Ended December 31,		
(Dollars in thousands)	2017	2016	2015
Maximum balance:			
Federal Home Loan Bank advances and Fed Funds	$ 70,419	$ 98,769	$ 98,769
Federal Reserve Bank	$ 1,000	$ 1,000	$ —
Fed Funds lines of credit	$ 17,501	$ 6,000	$ 2,901
Warehouse lines of credit	$ —	$ —	$ 2,300
Subordinated note	$ 10,000	$ 10,000	$ 10,000
Average balances:			
Federal Home Loan Bank advances and Fed Funds	$ 25,635	$ 26,259	$ 38,393
Federal Reserve Bank	$ 3	$ 3	$ —
Fed Funds lines of credit	$ 876	$ 16	$ 145
Warehouse lines of credit	$ —	$ —	$ 1,886
Subordinated note	$ 10,000	$ 10,000	$ 2,120
Weighted average interest rate:			
Federal Home Loan Bank advances and Fed Funds	1.26 %	0.98 %	0.82 %
Federal Reserve Bank	1.75 %	1.00 %	— %
Fed Funds lines of credit	1.30 %	0.77 %	0.42 %
Warehouse lines of credit	— %	— %	4.18 %
Subordinated note	6.50 %	6.50 %	6.79 %

	At December 31,		
(Dollars in thousands)	2017	2016	2015
Balance outstanding at end of year:			
Federal Home Loan Bank advances	$ 7,529	$ 12,670	$ 98,769
Total borrowings	$ 7,529	$ 12,670	$ 98,769
Weighted average interest rate of:			
Federal Home Loan Bank advances, at end of year	1.34 %	1.24 %	0.47 %

Subsidiary and Other Activities

The Company has one active subsidiary, the Bank, and the Bank has one inactive subsidiary. The Bank had no capital investment in its inactive subsidiary as of December 31, 2017.

Competition

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

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

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The Company attracts deposits through the branch office system. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds and other alternative investments. The Bank competes for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on the most recent branch deposit data provided by the FDIC, at June 30, 2017, 1st Security Bank of Washington's share of aggregate deposits in the market area consisting of the seven counties where the Company has branches was less than one percent.

Employees

At December 31, 2017, the Company had 326 full-time equivalent employees. Company employees are not represented by any collective bargaining group. The Company considers employee relations to be good.

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

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

		Position	
Name	Age (1)	Company	Bank
Joseph C. Adams	58	Director and Chief Executive Officer	Director and Chief Executive Officer
Matthew D. Mullet	39	Chief Financial Officer, Treasurer and Secretary	Chief Financial Officer
Robert B. Fuller	58	Chief Credit Officer	Chief Credit Officer
Dennis V. O'Leary	50	—	Chief Lending Officer
Drew B. Ness	53	—	Chief Operating Officer
Donn C. Costa	56	—	Executive Vice President, Home Lending Production
Debbie L. Steck	58	—	Executive Vice President, Home Lending Operations
Kelli B. Nielsen	46	—	Executive Vice President, Retail Banking and Marketing

(1) As of December 31, 2017.

Joseph C. Adams, age 58, is a director and has been the Chief Executive Officer of 1st Security Bank of Washington since July 2004. He joined 1st Security Bank of Washington in April 2003 as its Chief Financial Officer, when the Bank was Washington's Credit Union. Mr. Adams also served as Supervisory Committee Chairperson from 1993 to 1999. Mr. Adams is a lawyer having worked for Deloitte as a tax consultant, K&L Gates as a lawyer and then at Univar USA as a lawyer and Director, Regulatory Affairs. Mr. Adams received a Master's Degree equivalent from the Pacific Coast Banking School. Mr. Adams' legal and accounting backgrounds, as well as his duties as Chief Executive Officer of 1st Security Bank of Washington, bring a special knowledge of the financial, economic and regulatory challenges faced by the Bank which makes him well suited to educate the Board on these matters.

Matthew D. Mullet, age 39, joined 1st Security Bank of Washington in July 2011 and was appointed Chief Financial Officer in September 2011. Mr. Mullet started his banking career in June 2000 as a financial examiner with the Washington State Department of Financial Institutions, Division of Banks, where he worked until October 2004. From October 2004 until August 2010, Mr. Mullet was employed at Golf Savings Bank, Mountlake Terrace, WA, where he served in several financial capacities, including as Chief Financial Officer from May 2007 until August 2010. In

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August 2010, Golf Savings Bank was merged with Sterling Savings Bank, where Mr. Mullet held the position as Senior Vice President of the Home Loan Division until resigning and commencing work at 1st Security Bank of Washington.

Robert B. Fuller, age 58, joined 1st Security Bank of Washington as Chief Credit Officer in September of 2013. Prior to his employment with the Bank, Mr. Fuller served as Chief Financial Officer/Chief Credit Officer for Blueprint Capital, REIT in 2013, Chief Credit Officer for Core Business Bank during 2012, and Plaza Bank during 2011, and in credit administration at Golf Savings Bank/Sterling Bank during 2009 and 2010. Mr. Fuller also served as Executive Vice President, Chief Operating Officer, and Chief Financial Officer for Golf Savings Bank from March 2001 to September 2006 and was a member of the integration team for the Golf sale to Sterling Savings Bank. Mr. Fuller started his banking career at US Bank of Washington's mid-market production team and has over 30 years of banking experience.

Dennis V. O'Leary, age 50, joined 1st Security Bank of Washington as Senior Vice President - Consumer, Small Business and Construction Lending in August 2011 and currently holds the position of Chief Lending Officer. Prior to his employment with the Bank, Mr. O'Leary previously was employed by Sterling Savings Bank from July 2006 until August 2011 as Senior Vice President and Puget Sound Regional Director of the residential construction lending division. Sterling Savings Bank acquired Golf Savings Bank in 2006 where Mr. O'Leary had served as Executive Vice President, Commercial Real Estate Lending, having previously served in various senior lending positions at Golf Savings Bank since June 1985.

Drew B. Ness, age 53, joined 1st Security Bank of Washington as Chief Operating Officer in 2008. Mr. Ness has over 26 years of diverse banking experience, including retail branch sales and service, branch network and project management, and national customer service training. He served as Vice President and Manager of the Corporate Deposit Operations Department for Washington Federal, Seattle, Washington from February 2008 until August 2008, following its acquisition of First Mutual Bank. Mr. Ness served as Vice President and Administrative/Operations Manager of the Retail Banking Group at First Mutual Bank, Bellevue, Washington from 2004 through February 2008, and, prior to that, in various management positions for Bank of America in Seattle, Washington and Newport Beach, California.

Donn C. Costa, age 56, Executive Vice President, Home Lending, joined 1st Security Bank of Washington in October 2011 as Senior Vice President, Home Lending. He previously held the position of Executive Vice President at Sterling Savings Bank, Mountlake Terrace, Washington after the merger with Golf Savings Bank in August 2009, and held the position of Executive Vice President at Golf Savings Bank, Mountlake Terrace, Washington since 2006. With more than 30 years of home lending experience, Mr. Costa began as a loan officer at Lomas and Nettleton Mortgage Company in Mountlake Terrace in 1986.

Debbie L. Steck, age 58, Executive Vice President, Home Lending Operations, joined 1st Security Bank of Washington in September 2011. Prior to her employment at the Bank, she served as Chief Operating Officer and Vice President at Sterling Savings Bank after the merger with Golf Savings Bank in August 2009, and held that position with Golf Savings Bank for several years prior to that. Ms. Steck has over 30 years of experience in the mortgage industry. She currently serves on the Board of Directors for the Everett Gospel Mission.

Kelli B. Nielsen, age 46, Executive Vice President, Retail Banking and Marketing, joined 1st Security Bank of Washington in June 2016. Prior to her employment at the Bank, she served as Senior Vice President of Retail Banking and Marketing at Sound Community Bank and prior to that, Ms. Nielsen was Vice President, Sales and Service Manager of Retail Banking at Cascade Bank and its acquirer Opus Bank. Ms. Nielsen has 26 years of experience in the banking industry and started her banking career at Seafirst Bank and Bank of America.

HOW WE ARE REGULATED

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

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

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

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

Regulation of 1st Security Bank of Washington

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

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

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

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

Insurance of Accounts and Regulation by the FDIC. Through the DIF, the FDIC insures deposit accounts in 1st Security Bank of Washington up to $250,000 per separately insured depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. The Bank's deposit insurance premiums for the year ended December 31, 2017, were $535,000. Those premiums have been reduced in recent years due to management's focus on asset quality, risk management, and growing capital levels.

The Dodd-Frank Act requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. Based on the current reserve ratio of the DIF, FDIC assessment rates applicable to 1st Security Bank range from three basis points to 30 basis points, subject to certain adjustments where applicable for unsecured debt issued by the institution, brokered deposits, and unsecured debt of other FDIC-insured institutions. Under current regulations, if the reserve ratio becomes equal to, or greater than 2.0% and less than 2.5%, the assessment rates are scheduled to range from two basis points to 28 basis points (subject to adjustments as described above), and further reductions in rates may occur if the reserve ratio increases to 2.5% or more.

The FDIC conducts examinations of and requires reporting by state non-member banks, such as 1st Security Bank of Washington. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the DIF. No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation established in 1987 to recapitalize a predecessor deposit insurance fund. These assessments, which may be revised based upon the level of DIF deposits, will continue until the bonds mature from 2018 through 2020. This payment is assessed quarterly at an annualized rate applied to assessable assets. During 2017, the rate was 4.90%. 1st Security Bank of Washington and FS Bancorp have made no payments to the DIF.

The FDIC may terminate the deposit insurance of any insured depository institution, including 1st Security Bank of Washington, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily under certain circumstances. Management is aware of no existing circumstances which would result in termination of 1st Security Bank of Washington's deposit insurance.

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

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

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

At December 31, 2017, 1st Security Bank of Washington was categorized as well capitalized under the prompt corrective action regulations of the FDIC. For additional information, see “Capital Requirements” below and Note 14 of

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the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data,” of this Form 10 K.

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

Under the new capital regulations, the minimum capital ratios applicable to FS Bancorp and 1st Security Bank of Washington are: (1) a CET1 capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total risk-based capital ratio of 8.0% of risk-weighted assets; and (4) a leverage ratio (the ratio of Tier 1 capital to average total adjusted assets) of 4.0%. CET1 generally consists of common stock; retained earnings; accumulated other comprehensive income (“AOCI”) unless an institution elects to exclude AOCI from regulatory capital; and certain minority interests; all subject to applicable regulatory adjustments and deductions. Tier 1 capital generally consists of CET1 and noncumulative perpetual preferred stock. Tier 2 capital generally consists of other preferred stock and subordinated debt meeting certain conditions plus an amount of the allowance for loan and lease losses up to 1.25% of assets. Total capital is the sum of Tier 1 and Tier 2 capital.

In addition to the minimum capital requirements, a capital conservation buffer must be maintained by 1st Security Bank of Washington which consists of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, repurchasing shares, and paying discretionary bonuses. The new capital conservation buffer requirement was phased in beginning on January 1, 2016 when a buffer greater than 0.625% of risk-weighted assets was required. The capital conservation buffer increases each year until the capital conservation buffer requirement is fully phased in on January 1, 2019.

To be considered well capitalized, a depository institution must have a Tier 1 risk-based capital ratio of at least 8.00%, a total risk-based capital ratio of at least 10%, a CET1 capital ratio of at least 6.50% and a leverage ratio of at least 5.00% and not be subject to an individualized order, directive or agreement under which its primary federal banking regulator requires it to maintain a specific capital level.

At December 31, 2017, 1st Security Bank of Washington met the requirements to be well capitalized and met the fully phased in capital conservation buffer requirement. Management monitors the capital levels of the Bank to provide for current and future business opportunities and to meet regulatory guidelines for well capitalized institutions. The Bank’s actual capital ratios at December 31, 2017 and 2016 are presented in the following tables:

	Actual Ratio		For Capital Adequacy Purposes Ratio		For Capital Adequacy with Capital Buffer Ratio		To be Well Capitalized Under Prompt Corrective Action Provisions Ratio	
As of December 31, 2017								
Total risk-based capital (to risk-weighted assets)	16.25	%	8.00	%	9.25	%	10.00	%
Tier 1 risk-based capital								

(to risk-weighted assets)	15.00 %	6.00 %	7.25 %	8.00 %
Tier 1 leverage capital				
(to average assets)	12.61 %	4.00 %	N/A	5.00 %
CET1 capital				
(to risk-weighted assets)	15.00 %	4.50 %	5.75 %	6.50 %

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	Actual Ratio		For Capital Adequacy Purposes Ratio		For Capital Adequacy with Capital Buffer Ratio		To be Well Capitalized Under Prompt Corrective Action Provisions Ratio	
As of December 31, 2016								
Total risk-based capital (to risk-weighted assets)	13.87	%	8.00	%	8.63	%	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	12.62	%	6.00	%	6.63	%	8.00	%
Tier 1 leverage capital (to average assets)	10.33	%	4.00	%	N/A		5.00	%
CET1 capital (to risk-weighted assets)	12.62	%	4.50	%	5.13	%	6.50	%

The FDIC also has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution’s capital level is or may become inadequate in light of particular risks or circumstances. Management of 1st Security Bank of Washington believes that, under the current regulations, 1st Security Bank of Washington will continue to meet its minimum capital requirements in the foreseeable future.

For a complete description of the Bank’s required and actual capital levels on December 31, 2017, see Note 14 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data,” of this Form 10 K.

Standards for Safety and Soundness. The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to internal controls, information systems and internal audit systems; loan documentation; credit underwriting; interest rate risk exposure; asset growth; asset quality; earnings; and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution’s size and complexity and the nature and scope of its activities. The information security program must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that an institution fails to meet any of these guidelines, it may require an institution to submit to the FDIC an acceptable plan to achieve compliance.

Federal Home Loan Bank System. The FHLB of Des Moines is one of 11 regional FHLBs that administer the home financing credit function of savings institutions. The FHLBs are subject to the oversight of the Federal Housing Finance Agency and each FHLB serves as a reserve or central bank for its members within its assigned region. The FHLBs are funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System and makes loans or advances to members in accordance with policies and procedures established by the Board of Directors of the FHLB, which are subject to the oversight of the Federal Housing Finance Agency. All advances from the FHLB are required to be fully secured by sufficient collateral as determined by the FHLB. In addition, members are required to purchase stock equal to 4.0% of advances. That stock may be redeemed if advances are paid down. See "Business - Deposit Activities and Other Sources of Funds - Debt." At December 31, 2017, 1st Security Bank of Washington had $2.9 million in FHLB of Des Moines stock, which was in compliance with this requirement.

Other than as noted above, during the year ended December 31, 2017, the FHLB of Des Moines did not repurchase any of its membership stock from 1st Security Bank of Washington. The FHLB pays dividends quarterly, and 1st Security Bank of Washington received $112,000 in dividends during the year ended December 31, 2017.

The FHLBs continue to contribute to low- and moderately-priced housing programs through direct loans or interest subsidies on advances targeted for community investment and low- and moderate-income housing projects. These contributions have adversely affected the level of FHLB dividends paid and could continue to do so in the future. These contributions could also have an adverse effect on the value of FHLB stock in the future. A reduction in value of 1st Security Bank of Washington's FHLB stock may result in a decrease in net income.

Activities and Investments of Insured State-Chartered Financial Institutions. Federal law generally limits the activities and equity investments of FDIC insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (1) acquiring or retaining a majority interest in a subsidiary, (2) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investments may not exceed 2% of the bank's total assets, (3) acquiring up to 10% of the voting stock of a company that solely provides or reinsures directors' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (4) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

Dividends. Dividends from 1st Security Bank of Washington constitute a major source of funds for dividends in future periods that may be paid by FS Bancorp to shareholders. The amount of dividends payable by 1st Security Bank of Washington to FS Bancorp depends upon the Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies. According to Washington law, 1st Security Bank of Washington may not declare or pay a cash dividend on its capital stock if it would cause its net worth to be reduced below (1) the amount required for liquidation accounts or (2) the net worth requirements, if any, imposed by the Director of the DFI. Dividends on 1st Security Bank of Washington's capital stock may not be paid in an aggregate amount greater than the aggregate retained earnings of 1st Security Bank of Washington, without the approval of the Director of the DFI. The Bank paid $1.9 million in dividends to the holding company in 2017.

The amount of dividends actually paid during any one period will be strongly affected by 1st Security Bank of Washington's policy of maintaining a strong capital position. Federal law further provides that no insured depository institution may pay a cash dividend if it would cause the institution to be "undercapitalized," as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments are deemed to constitute an unsafe and unsound practice.

Affiliate Transactions. FS Bancorp and 1st Security Bank of Washington are separate and distinct legal entities. FS Bancorp (and any non-bank subsidiary of FS Bancorp) is an affiliate of 1st Security Bank of Washington. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates. Transactions deemed to be "covered transactions" under Section 23A of the Federal Reserve Act and between a bank and an affiliate are limited to 10% of the bank subsidiary's capital and surplus and, with respect to all affiliates, to an aggregate of 20% of the bank's capital and surplus. Further, covered transactions that are loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that covered transactions and certain other transactions listed in Section 23B of the Federal Reserve Act between a bank and its affiliates be on terms as favorable to the bank as transactions with non-affiliates.

Community Reinvestment Act. 1st Security Bank of Washington is also subject to the provisions of the Community Reinvestment Act of 1977 ("CRA"), which requires the appropriate federal bank regulatory agency to assess a bank's performance under the CRA in meeting the credit needs of the community serviced by the Bank, including low and moderate income neighborhoods. The regulatory agency's assessment of a bank's record is made available to the public. Further, a bank's CRA performance rating must be considered in connection with a bank's application to, among other things, establish a new branch office that will accept deposits, relocate an existing office or merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. 1st

Security Bank of Washington received a “satisfactory” rating during its most recent CRA examination.

Privacy Standards. 1st Security Bank of Washington is subject to FDIC regulations implementing the privacy protection provisions of the Gramm-Leach-Bliley Act of 1999. These regulations require 1st Security Bank of Washington to disclose its privacy policy, including informing consumers of its information sharing practices and informing consumers of its rights to opt out of certain practices.

Environmental Issues Associated with Real Estate Lending. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") is a federal statute that generally imposes strict liability on, all prior and present "owners and operators" of sites containing hazardous waste. However, Congress asked to protect secured creditors by providing that the term "owner and operator" excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this "secured creditor exemption" has been the subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan. To the extent that legal uncertainty exists in this area, all creditors, including 1st Security Bank of Washington, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System. The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the regional Federal Reserve Bank. Negotiable order of withdrawal ("NOW") accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to the reserve requirements, as are any non-personal time deposits at a savings bank. As of December 31, 2017, 1st Security Bank of Washington's deposit with the Federal Reserve Bank and vault cash exceeded its reserve requirements.

Other Consumer Protection Laws and Regulations. The Dodd-Frank Act established the CFPB and empowered it to exercise broad regulatory, supervisory and enforcement authority with respect to both new and existing consumer financial protection laws. 1st Security Bank of Washington is subject to consumer protection regulations issued by the CFPB, but as a financial institution with assets of less than $10 billion, 1st Security Bank of Washington is generally subject to supervision and enforcement by the FDIC and the DFI with respect to compliance with consumer financial protection laws and CFPB regulations.

1st Security Bank of Washington is subject to a broad array of federal and state consumer protection laws and regulations that govern almost every aspect of its business relationships with consumers. While the list set forth below is not exhaustive, these include the Truth-in-Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Right to Financial Privacy Act, the Home Ownership and Equity Protection Act, the Consumer Leasing Act, the Fair Credit Billing Act, the Homeowners Protection Act, the Check Clearing for the 21st Century Act, laws governing flood insurance, laws governing consumer protections in connection with the sale of insurance, federal and state laws prohibiting unfair and deceptive business practices, and various regulations that implement the foregoing. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans, and providing other services. Failure to comply with these laws and regulations can subject 1st Security Bank of Washington to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

Regulation and Supervision of FS Bancorp

General. FS Bancorp is a bank holding company registered with the Federal Reserve and is the sole shareholder of 1st Security Bank of Washington. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended ("BHCA"), and the regulations promulgated there under. This regulation and oversight is generally intended to ensure that FS Bancorp limits its activities to those allowed by law and that it operates in a safe and sound manner without endangering the financial health of 1st Security Bank of Washington.

As a bank holding company, FS Bancorp is required to file quarterly and annual reports with the Federal Reserve and any additional information required by the Federal Reserve and is subject to regular examinations by the Federal Reserve. The Federal Reserve also has extensive enforcement authority over bank holding companies, including the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices.

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The Bank Holding Company Act. Under the BHCA, FS Bancorp is supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Dodd-Frank Act provides that a bank holding company should serve as a source of strength to its subsidiary banks by having the ability to provide financial assistance to its subsidiary banks during periods of financial stress to the bank. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. No regulations have yet been proposed by the Federal Reserve to implement the source of strength doctrine required by the Dodd-Frank Act. FS Bancorp and any subsidiaries that it may control are considered "affiliates" of 1st Security Bank of Washington within the meaning of the Federal Reserve Act, and transactions between 1st Security Bank of Washington and its affiliates are subject to numerous restrictions. With some exceptions, FS Bancorp and its subsidiaries are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by FS Bancorp or its subsidiaries.

Acquisitions. The BHCA prohibits a bank holding company, with certain exceptions, from acquiring ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. Under the BHCA, the Federal Reserve may approve the ownership of shares by a bank holding company in any company, the activities of which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto. These activities include: operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks, and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

Regulatory Capital Requirements. Bank holding companies like FS Bancorp are subject to capital adequacy requirements of the Federal Reserve under the BHCA and the regulations of the Federal Reserve. For a bank holding company with less than $1.0 billion in assets, the capital guidelines apply on a bank only basis, and the Federal Reserve expects the holding company's subsidiary bank to be well capitalized under the prompt corrective action regulations. If FS Bancorp were subject to regulatory guidelines for bank holding companies with $1.0 billion or more in assets at December 31, 2017, FS Bancorp would have exceeded all regulatory requirements.

The Company's regulatory capital amounts and ratios at December 31, 2017 are presented in the following table.

	Actual		For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
At December 31, 2017								
Total risk-based capital	$ 129,427	15.70 %	$ 65,965	8.00 %	$ 76,272	9.25 %	$ 82,456	10.00 %

(to risk-weighted assets)												
Tier 1 risk-based capital (to risk-weighted assets)	$	119,111	14.45 %	$	49,474	6.00	%	$ 59,781	7.25	%	$ 65,965	8.00 %
Tier 1 leverage capital (to average assets)	$	119,111	12.13 %	$	39,279	4.00	%	N/A	N/A		$ 49,099	5.00 %
CET1 capital (to risk-weighted assets)	$	119,111	14.45 %	$	37,105	4.50	%	$ 47,412	5.75	%	$ 53,597	6.50 %

For additional information, see Note 14 to the Consolidated Financial Statements contained in “Item 8. Financial Statements and Supplementary Data” of this Form 10 K.

Interstate Banking. The Federal Reserve may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the holding company’s

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home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the law of the host state. Nor may the Federal Reserve approve an application if the applicant controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

The federal banking agencies are generally authorized to approve interstate merger transactions without regard to whether the transaction is prohibited by the law of any state. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions are also subject to the nationwide and statewide insured deposit concentration amounts described above.

Restrictions on Dividends and Stock Repurchases. FS Bancorp's ability to declare and pay dividends is subject to the Federal Reserve limits and Washington law, and it may depend on its ability to receive dividends received from 1st Security Bank of Washington.

Federal Reserve policy limits the payment of a cash dividend by a bank holding company if the holding company's net income for the past year is not sufficient to cover both the cash dividend and a rate of earnings retention that is consistent with capital needs, asset quality and overall financial condition. A bank holding company that does not meet any applicable capital standard would not be able to pay any cash dividends under this policy. A bank holding company not subject to consolidated capital requirements is expected not to pay dividends unless its debt-to-equity ratio is less than 1:1, and it meets certain additional criteria. The Federal Reserve also has indicated that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends.

Except for a company that meets the applicable standard to be considered a well capitalized and well-managed bank holding company and is not subject to any unresolved supervisory issues, a bank holding company is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation or regulatory order, condition, or written agreement.

Under Washington corporate law, FS Bancorp generally may not pay dividends if after that payment it would not be able to pay its liabilities as they become due in the usual course of business, or its total assets would be less than the sum of its total liabilities.

Federal Securities Law. The stock of FS Bancorp is registered with the SEC under the Securities Exchange Act of 1934, as amended. As a result, FS Bancorp is subject to the information, proxy solicitation, insider trading restrictions, and other requirements under the Securities Exchange Act of 1934.

FS Bancorp stock held by persons who are affiliates of FS Bancorp may not be resold without registration unless sold in accordance with certain resale restrictions. Affiliates are generally considered to be officers, directors and principal shareholders. If FS Bancorp meets specified current public information requirements, each affiliate of FS Bancorp will be able to sell in the public market, without registration, a limited number of shares in any three-month period.

Sarbanes-Oxley Act of 2002. As a public company that files periodic reports with the SEC, under the Securities Exchange Act of 1934, FS Bancorp is subject to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), which addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

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The Dodd-Frank Act. The Dodd-Frank Act of 2010 imposed new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions, and implements new capital regulations that FS Bancorp and 1st Security Bank of Washington have and will become subject to and that are discussed above under the section entitled "Regulation of 1st Security Bank of Washington - Capital Requirements."

In addition, among other changes, the Dodd-Frank Act requires public companies like FS Bancorp, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a "say on pay" vote every one, two, or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions, or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees. For certain of these changes, the implementing regulations have not been promulgated, so the full impact of the Dodd-Frank Act on public companies cannot be determined at this time.

TAXATION

Federal Taxation

General. FS Bancorp and 1st Security Bank of Washington are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to FS Bancorp. 1st Security Bank of Washington is no longer subject to U.S. federal income tax examinations by tax authorities for years ended before 2014, and income tax returns have not been audited for the past six years, 2012 to 2017. See Note 11 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data" of this Form 10 K.

On December 22, 2017, the U.S. Government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act amends the Internal Revenue Code to reduce tax rates and modify policies, credits, and deductions for individuals and businesses. For businesses, the Tax Act reduces the corporate federal income tax rate from a maximum of 35% to a flat 21% rate. The corporate income tax rate reduction was effective January 1, 2018. The Tax Act required a revaluation the Company's deferred tax assets and liabilities to account for the future impact of lower corporate income tax rates and other provisions of the legislation. As a result of the Company's revaluation, the Company recognized $396,000 in tax benefit due to a net deferred tax liability position.

FS Bancorp files a consolidated federal income tax return with 1st Security Bank of Washington. Accordingly, any cash distributions made by FS Bancorp to its shareholders would be considered to be taxable dividends and not as a non taxable return of capital to shareholders for federal and state tax purposes.

Method of Accounting. For federal income tax purposes, FS Bancorp currently reports its income and expenses on the accrual method of accounting and uses a fiscal year ending on December 31 for filing its federal income tax return.

Minimum Tax. The Internal Revenue Code imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, called alternative minimum taxable income. The alternative minimum tax is payable to the extent such alternative minimum taxable income is in excess of an exemption amount. Net operating losses can offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years.

Corporate Dividends Received Deduction. FS Bancorp may eliminate from its income dividends received from 1st Security Bank of Washington as a wholly owned subsidiary of FS Bancorp if it elects to file a consolidated return with 1st Security Bank of Washington. The corporate dividends-received deduction is 100%, or 80%, in the case of dividends received from corporations with which a corporate recipient does not file a consolidated tax return, depending on the level of stock ownership of the payor of the dividend. Corporations which own less than 20% of the stock of a corporation distributing a dividend may deduct 70% of dividends received or accrued on their behalf.

Washington Taxation

The Company and the Bank are subject to a business and occupation tax which is imposed under Washington law at the rate of 1.50% of gross receipts. Interest received on loans secured by mortgages or deeds of trust on residential properties, residential mortgage-backed securities, and certain U.S. Government and agency securities are not subject to this tax.

Item 1A. Risk Factors

An investment in our common stock is subject to risks inherent in our business. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included in this report and our other filings with the SEC. In addition to the risks and uncertainties described below, other risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition, capital levels, cash flows, liquidity, results of operations, and prospects. The market price of our common stock could decline significantly due to any of these identified or other risks, and you could lose some or all of your investment. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements. This report is qualified in its entirety by these risk factors.

Risks Related to Our Business

Our business may be adversely affected by downturns in the national economy and in the economies in our market areas.

Our primary market area is concentrated in the Puget Sound region of Washington. Our business is directly affected by market conditions, trends in industry and finance, legislative and regulatory changes, and changes in governmental monetary and fiscal policies, and inflation, all of which are beyond our control. General economic conditions, including inflation, unemployment and money supply fluctuations, also may affect our profitability adversely. A decline in the economies of the counties in which we operate could have a material adverse effect on our business, financial condition, results of operations, and prospects.

While real estate values and unemployment rates have recently improved, a deterioration in economic conditions in the market areas we serve could result in loan losses beyond that which is provided for in our allowance for loan losses and could result in the following consequences, any of which could have a material adverse effect on the business, financial condition, and results of operations:

- demand for our products and services may decline, possibly resulting in a decrease in our total loans or assets;
- loan delinquencies, problem assets and foreclosures may increase;
- we may increase our allowance for loan losses;
- collateral for our loans may further decline in value, in turn reducing customer’s borrowing power, reducing the value of assets and collateral associated with existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our low-cost or noninterest-bearing deposits may decrease.

A decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loan portfolios are geographically diverse. Many of the loans in our portfolio are secured by real estate or fixtures attached to real estate. Deterioration in the real estate markets where collateral for a mortgage loan is located could negatively affect the borrower’s ability to repay the loan and the value of the collateral securing the loan. Real estate values are affected by various other factors, including changes in general or regional economic conditions, governmental rules or policies, and natural disasters such as earthquakes. If we are required

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to liquidate a significant amount of collateral during a period of reduced real estate values, our financial condition and profitability could be adversely affected.

Adverse changes in the regional and general economy could reduce our growth rate, impair our ability to collect loans, and generally have a negative effect on our financial condition and results of operations.

Our loan portfolio possesses increased risk due to a large percentage of consumer loans.

Our consumer loans accounted for $208.7 million, or 27.0% of our total gross loan portfolio as of December 31, 2017, of which $130.2 million (62.4% of total consumer loans) consisted of indirect home improvement loans (some of which were not secured by a lien on the real property), $41.0 million (19.7% of total consumer loans) consisted of solar loans, $35.4 million (17.0% of total consumer loans) consisted of marine loans secured by boats, $2.1 million (1.0% of total consumer loans) consisted of other consumer loans, which includes personal lines of credit, automobile, direct home improvement, loans on deposit, and recreational loans. Generally, we consider these types of loans to involve a higher degree of risk compared to first mortgage loans on owner-occupied, one-to-four-family residential properties. As a result of our large portfolio of consumer loans, it may become necessary to increase the level of provision for our loan losses, which would reduce profits. Consumer loans generally entail greater risk than do one-to-four-family residential mortgage loans, particularly in the case of loans that are secured by rapidly depreciable assets, such as automobiles and boats. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance.

Most of our consumer loans are originated indirectly by or through third parties, which presents greater risk than our direct lending products which involves direct contact between us and the borrower. Unlike a direct loan where the borrower makes an application directly to us, in these loans the dealer, who has a direct financial interest in the loan transaction, assists the borrower in preparing the loan application. Although we disburse the loan proceeds directly to the dealer upon receipt of a “completion certificate” signed by the borrower, because we do not have direct contact with the borrower, these loans may be more susceptible to a material misstatement on the loan application or having the loan proceeds being misused by the borrower or the dealer. In addition, if the work is not properly performed, the borrower may cease payment on the loan until the problem is rectified. Most fixture and solar loans have a UCC-2 security interest filing; however, there are no guarantees on our ability to collect on that security interest given the limited stand-alone value of used fixtures.

Indirect home improvement and solar loans totaled $171.2 million, or 22.1% of our total gross loan portfolio at December 31, 2017, and are originated through a network of 88 home improvement contractors and dealers located in Washington, Oregon, California, Idaho, and Colorado. At December 31, 2017, the Company had $40.8 million in solar loans to borrowers that reside in California. Adverse economic conditions in California, including an increase in the level of unemployment, or a decline in real estate values could adversely affect the ability of these borrowers to make loan payments to us.

In addition, we rely on six dealers for a majority, or 56.7% of our loan volume so the loss of one of these dealers can have a significant effect on our loan origination volume. See “Item 1. Business - Lending Activities - Consumer Lending” and “- Asset Quality”.

Our business could suffer if we are unsuccessful in making, continuing and growing relationships with home improvement contractors and dealers.

Our indirect home improvement lending, which is the largest component of our consumer loan portfolio, is reliant on our relationships with home improvement contractors and dealers. In particular, our indirect home improvement loan operations depend in large part upon our ability to establish and maintain relationships with reputable contractors and dealers who originate loans at the point of sale. Our indirect home improvement contractor/dealer network is currently comprised of 88 active contractors and dealers with businesses located throughout Washington, Oregon, California, Idaho, and Colorado, with approximately six contractors/dealers responsible for more than half of this loan volume. Indirect home improvement and solar loans totaled $171.2 million, or 22.1% of our total gross loan portfolio, at December 31, 2017, reflecting approximately 14,000 loans with an average balance of approximately $12,000.

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We have relationships with home improvement contractors/dealers, however, the relationships generally are not exclusive, some of them are newly established and they may be terminated at any time. If there is another economic downturn and contraction of credit to both contractors/dealers and their customers, there could be an increase in business closures and our existing contractor/dealer base could experience decreased sales and loan volume, which may have an adverse effect on our business, results of operations and financial condition. In addition, if a competitor were to offer better service or more attractive loan products to our contractor/dealer partners, it is possible that our partners would terminate their relationships with us or recommend customers to our competitors. If we are unable to continue to grow our existing relationships and develop new relationships, our results of operations and financial condition could be adversely affected.

In the fourth quarter of 2012, we expanded consumer loan originations in California which enabled us to increase annual originations of California consumer loans from $2.5 million in 2012 to $20.2 million in 2017. We have adopted limits on California lending to be no more than 100% of total risk-based capital. At December 31, 2017, the maximum level of California originated consumer loans was $134.0 million. At December 31, 2017, we held $44.7 million of consumer loans to borrowers located in California.

A significant portion of our business involves commercial real estate lending which is subject to various risks that could adversely impact our results of operations and financial condition.

At December 31, 2017, our loan portfolio included $108.1 million of commercial real estate and multi-family real estate loans, or 14.0% of our total gross loan portfolio, compared to $93.4 million, or 15.4%, at December 31, 2016. We have been increasing and intend to continue to increase, subject to market demand, the origination of commercial and multi-family real estate loans. The credit risk related to these types of loans is considered to be greater than the risk related to one-to-four-family residential loans because the repayment of commercial and multi-family real estate loans typically is dependent on the successful operation and income stream of the property securing the loan and the value of the real estate securing the loan as collateral, which can be significantly affected by economic conditions.

Our renewed focus on these types of lending will increase the risk profile relative to traditional one-to-four-family lenders as we continue to implement our business strategy. Although commercial and multi-family real estate loans are intended to enhance the average yield of the earning assets, they do involve a different, and possibly higher, level of risk of delinquency or collection than generally associated with one-to-four-family loans for a number of reasons. Among other factors, these loans involve larger balances to a single borrower or groups of related borrowers. Since commercial real estate and multi-family real estate loans generally have large balances, if we make any errors in judgment in the collectability of these loans, we may need to significantly increase the provision for loan losses since any resulting charge offs will be larger on a per loan basis. Consequently, this could materially adversely affect our future earnings.

Collateral evaluation for these types of loans also requires a more detailed analysis at the time of loan underwriting and on an ongoing basis. In addition, most of our commercial and multi-family loans are not fully amortizing and include balloon payments upon maturity. Balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. Finally, if foreclosure occurs on a commercial real estate loan, the holding period for the collateral, if any, typically is longer than for a one-to-four-family residence because the secondary market for most types of commercial and multi-family real estate is not readily liquid, so we have less opportunity to mitigate credit risk by selling part or all of our interest in these assets. See “Item 1. Business - Lending Activities - Commercial Real Estate Lending” of this Form 10 K.

Repayment of our commercial business loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.

At December 31, 2017, our commercial business loan portfolio included $83.3 million of commercial and industrial loans, or 10.8% of our total gross loan portfolio, compared to $65.8 million, or 10.9% at December 31, 2016, and warehouse lending of $41.4 million, or 5.3% compared to $32.9 million, or 5.4% at December 31, 2016. Commercial business lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral-based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable and collateral securing these loans may fluctuate in value. This collateral may consist of equipment, inventory, accounts receivable, or other business assets. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing these loans may depreciate over time, may be difficult to appraise, may be illiquid, and may fluctuate in value based on the specific type of business and equipment. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself, which, in turn, is often dependent in part upon general economic conditions and secondarily on the underlying collateral provided by the borrower.

We continue to expand residential construction lending which is subject to various risks that could adversely impact our results of operations and financial condition.

We make real estate construction loans to individuals and builders, primarily for the construction of residential properties. We originate these loans whether or not the collateral property underlying the loan is under contract for sale. At December 31, 2017, construction and development loans totaled $143.1 million, or 18.5% of our total gross loan portfolio (excluding $78.9 million of undisbursed construction loan commitments), of which $113.1 million were for residential real estate projects. This compares to construction and development loans of $94.5 million, or 15.6% of our total loan portfolio at December 31, 2016, or an increase of 51.5% during the past year. Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate.

In general, construction lending involves additional risks because funds are advanced upon estimates of costs in relation to values associated with the completed project. Construction lending involves additional risks when compared with permanent residential lending because funds are advances upon the collateral for the project based on an estimate of costs that will produce a future value at completion. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the complete project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the completed project loan-to-value ratio. Changes in demand for new housing and higher than anticipated building costs may cause actual results to vary significantly from those estimated. For these reasons, this type of lending also typically involves higher loan principal amounts and may be concentrated with a small number of builders. A downturn in housing, or the real estate market, could increase delinquencies, defaults and foreclosures, and significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. Some of the builders we deal with have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss. In addition, during the term of most of our construction loans, no payment from the borrower is required since the accumulated interest is added to the principal of the loan through an interest reserve. As a result, these loans often involve the disbursement of funds with repayment substantially dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property or obtain permanent take-out financing, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of a completed project proves to be overstated, we may have inadequate security for the repayment of the loan upon completion of construction of the project and may incur a loss. Because construction loans require active monitoring of the building process, including cost comparisons and on-site inspections, these loans are more difficult and costly to monitor.

Increases in market rates of interest may have a more pronounced effect on construction loans by rapidly increasing the end-purchaser’s borrowing costs, thereby possibly reducing the homeowner's ability to finance the home upon completion or the overall demand for the project. Properties under construction are often difficult to sell and typically must be completed in order to be successfully sold which also complicates the process of working out problem construction loans. This may require us to advance additional funds and/or contract with another builder to complete construction and assume the market risk of selling the project at a future market price, which may or may not enable us to fully recover unpaid loan funds and associated construction and liquidation costs. Furthermore, in the case of speculative construction loans, there is the added risk associated with identifying an end-purchaser for the finished project. At December 31, 2017, outstanding construction and development loans totaled $143.1 million of which $80.0 million was comprised of speculative one-to-four-family construction loans and $11.5 million of land acquisition and development loans. Approximately $4.0 million of our residential construction loans at December 31, 2017 were made to finance the construction of owner-occupied homes and are structured to be converted to permanent loans at the end of the construction phase. Total committed, including unfunded construction and development loans at December 31, 2017 was $222.0 million.

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Loans on land under development or held for future construction pose additional risks because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor themselves to repay principal and interest. No real estate construction and development loans were non-performing at December 31, 2017. A material increase in our non-performing construction and development loans could have a material adverse effect on our financial condition and results of operation.

Our residential mortgage warehouse lending and construction warehouse lending programs are subject to various risks that could adversely impact our results of operations and financial condition.

Our residential mortgage warehouse lending program focuses on six Pacific Northwest mortgage banking companies. Short term funding is provided to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. Our warehouse lending lines are secured by the underlying notes associated with mortgage loans made to borrowers by the mortgage banking company and we generally require guarantees from the principle shareholder(s) of the mortgage banking company. Because these loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down our outstanding loan before being dispersed to the mortgage bank, interest rate fluctuation is also a key risk factor affecting repayment. At December 31, 2017, we had approved residential warehouse lending lines in varying amounts from $3.0 million to $9.0 million with each of the six companies, for an aggregate amount of $35.0 million. During the year ended December 31, 2017, we processed approximately 1,000 loans and funded approximately $327.6 million under this program. Our residential mortgage warehouse related gross revenues totaled $500,000 for the year ended December 31, 2017. At December 31, 2017, there was $7.4 million in residential warehouse lines outstanding, compared to $7.8 million outstanding at December 31, 2016.

The Company also has commercial construction warehouse lines secured by notes on construction loans and typically guaranteed by principles with experience in construction lending. At December 31, 2017, the Company had $84.7 million in approved commercial construction warehouse lending lines for nine companies. The commitments range from $5.0 million to $21.0 million. At December 31, 2017, there was $34.0 million outstanding, compared to $49.0 million approved in commercial warehouse lending lines for eight companies with $25.1 million outstanding at December 31, 2016.

There are numerous risks associated with this type of lending, which include, without limitation, (i) credit risks relating to the mortgage bankers that borrow from us, (ii) the risk of intentional misrepresentation or fraud by any of these mortgage bankers, (iii) changes in the market value of mortgage loans originated by the mortgage banker, the sale of which is the expected source of repayment of the borrowings under the warehouse line of credit, due to changes in interest rates during the time in warehouse, (iv) unsalable or impaired mortgage loans originated, which could lead to decreased collateral value and the failure of a purchaser of the mortgage loan to purchase the loan from the mortgage banker, and (v) the volatility of mortgage loan originations.

Additionally, the impact of interest rates on our residential mortgage warehouse lending business can be significant. Changes in interest rates can impact the number of residential mortgages originated and initially funded under our residential mortgage warehouse lines of credit and thus our residential mortgage warehouse related revenues and may also impact repayment of our commercial construction warehouse lines. A decline in mortgage rates generally increases the demand for mortgage loans. Conversely, in a constant or increasing rate environment, we would expect fewer loans to be originated.

The level of our commercial real estate loan portfolio may subject us to additional regulatory scrutiny.

The FDIC, the Federal Reserve and the Office of the Comptroller of the Currency have promulgated joint guidance on sound risk management practices for financial institutions with concentrations in commercial real estate lending. Under this guidance, a financial institution that, like us, is actively involved in commercial real estate lending should perform a risk assessment to identify concentrations. A financial institution may have a concentration in commercial real estate lending if, among other factors (i) total reported loans for construction, land development and other land represent 100% or more of total capital, or (ii) total reported loans secured by multi-family and non-farm non-residential properties, loans for construction, land development and other land, and loans otherwise sensitive to the general commercial real estate market, including loans to commercial real estate related entities, represent 300% or more of total capital. The particular focus of the guidance is on exposure to commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be at greater risk to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The guidance states that management should employ heightened risk management practices including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing.

Based on factor (i) mentioned above, we have concluded that we have a concentration in commercial real estate lending because our total reported loans for construction, land development, and other land at December 31, 2017 represent 100% or more of total capital. While we believe we have implemented policies and procedures with respect to our commercial real estate loan portfolio consistent with this guidance, bank regulators could require us to implement additional policies and procedures consistent with their interpretation of the guidance that may result in additional costs to us.

Our lending limit may limit growth.

The Board of Directors has implemented a policy lending limit that it believes matches the Washington State legal lending limit. Our policy limits loans to one borrower and the borrower’s related entities to 20% of our unimpaired capital and surplus, or $27.5 million at December 31, 2017. Management has adopted an internal lending limit of a maximum of 80% of the Bank’s legal lending limit for risk mitigation purposes and all loans over this limit require approval from the AQC. These amounts are significantly less than that of many of our competitors and may discourage potential commercial borrowers who have credit needs in excess of our lending limit from doing business with us. The lending limit also impacts the efficiency of our commercial lending operation because it tends to lower the average loan size, which means a higher number of transactions have to be generated to achieve the same portfolio volume. We can accommodate larger loans by selling participations in those loans to other financial institutions, but this strategy is not efficient or always available. We may not be able to attract or maintain clients seeking larger loans or may not be able to sell participations in these loans on terms that are considered favorable.

Revenue from mortgage banking operations are sensitive to changes in economic conditions, decreased economic activity, a slowdown in the housing market, higher interest rates or new legislation and may adversely impact our financial condition and results of operations.

Our mortgage banking program, which we restarted in the fourth quarter of 2011 in an effort to diversify our revenue streams and to generate additional income is dependent upon our ability to originate and sell loans to investors. Mortgage revenues are primarily generated from gains on the sale of one-to-four-family residential loans underwritten to programs currently offered by Fannie Mae, Freddie Mac, Ginnie Mae, FHA, VA, USDA Rural Housing, the FHLB, and other non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. We sell loans on both a servicing retained and servicing released basis utilizing market execution analysis and customer relationships as the criteria. Any future changes in these programs, our eligibility to participate in these programs, the criteria for loans to be accepted, or laws that significantly affect the activity of these entities could, in turn, materially adversely affect the success of our mortgage banking program and, consequently, our results of operations.

Mortgage loan production levels are sensitive to changes in economic conditions and can suffer from decreased economic activity, a slowdown in the housing market or higher interest rates. Generally, any sustained period of decreased economic activity or higher interest rates could adversely affect mortgage originations and, consequently, adversely affect income from mortgage lending activities.

In the past several years, as a result of government actions and other economic factors related to the economic downturn, interest rates have been at historically low levels. In December 2017, the Federal Reserve slightly increased the targeted Fed Funds rate by 25 basis points for the third time within a year and intends further increases during 2018 subject to economic conditions. As the Federal Reserve increases the Fed Funds rate, refinancing activity typically declines and

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new home purchases may be negatively impacted. To the extent that market interest rates increase in the future, our ability to originate mortgage loans held for sale may decrease, resulting in fewer loans that are available to be sold to investors. This would adversely affect our ability to generate mortgage revenues, and consequently noninterest income. Because interest rates depend on factors outside of our control, we cannot eliminate the interest rate risk associated with our mortgage operations.

Our results of operations will also be affected by the amount of noninterest expense associated with mortgage banking activities, such as salaries and employee benefits, occupancy, equipment and data processing expense, and other operating costs. If we cannot generate a sufficient volume of loans for sale, our results of operations may be adversely affected. In addition, during periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

When we sell or securitize mortgage loans in the ordinary course of business, we are required to make certain representations and warranties to the purchaser about the mortgage loans and the manner in which they were originated. Under these agreements, we may be required to repurchase mortgage loans if we have breached any of these representations or warranties, in which case we may record a loss. In addition, if repurchase and indemnity demands increase on loans that we sell from our portfolios, our liquidity, results of operations, and financial condition could be adversely affected.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could be reduced.

While conditions in the housing and real estate markets and economic conditions in our market areas have recently improved, if slow economic conditions return or real estate values and sales deteriorate, we may experience higher delinquencies and credit losses. As a result, we could be required to increase our provision for loan losses and to charge-off additional loans in the future. If charge-offs in future periods exceed the allowance for loan losses, we may need additional provisions to replenish the allowance for loan and lease losses.

We maintain our allowance for loan losses at a level that management considers adequate to absorb probable loan losses based on an analysis of our portfolio and market environment. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review loans and our historical loss and delinquency experience, and evaluate economic conditions. Management recognizes that significant new growth in loan portfolios, new loan products, and the refinancing of existing loans can result in portfolios comprised of unseasoned loans that may not perform in a historical or projected manner. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover actual losses, resulting in additional provisions for loan losses to replenish the allowance for loan losses. Deterioration in economic conditions, new information regarding existing loans, identification of additional problem loans or relationships, and other factors, both within and outside of our control, may increase our loan charge-offs and/or may also otherwise also require an increase in our provision for loan losses. In addition, the Financial Accounting Standards Board has adopted new accounting standard 2016-13 that will be effective for our first fiscal year after December 15, 2019. This standard, referred to as Current Expected Credit Loss, or CECL, will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for credit losses. This will change the current method of providing allowances for credit losses that are probable, which would likely require us to increase our allowance for loan losses, and to greatly increase the types of data we would need to collect and review to determine the appropriate level of the allowance for loan losses. Any increase in our allowance for loan losses or expenses incurred to determine the appropriate level of the allowance for loan losses may have a material adverse effect on our financial condition and results of operations. Management also anticipates any change to our required allowance for loan losses to impact our capital levels in 2020 when the new standards will be adopted. For more on this new accounting standard, see Note 1 of the

Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data” of this Form 10-K.

Our allowance for loan losses was 1.4% of total gross loans, and 1,035.2% of non-performing loans at December 31, 2017, compared to 1.7% of total gross loans, and 1,416.2% of non-performing loans at December 31, 2016. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs based on their judgment about information

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available to them at the time of their examination. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations, and capital.

The unseasoned nature of our commercial business, commercial construction, and commercial real estate portfolios may result in difficulties in judging collectability, which may lead to additional provisions or charge-offs, which would reduce our profits.

As a result of our rapid growth, a significant portion of our loan portfolio at any given time is of relatively recent origin. Typically, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time (which varies by loan duration and loan type), a process referred to as "seasoning." During the period from January 1, 2012 through December 31, 2017, we originated $1.1 billion of commercial loans, including loans in process, with an outstanding balance of $396.1 million, at December 31, 2017. As a result, a significant portion of the portfolio is relatively unseasoned and some borrowers may not have had sufficient time to perform to properly indicate the magnitude of potential losses. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which could have a material adverse effect on our business, financial condition, results of operations, and growth prospects.

Our business may be adversely affected by credit risk associated with residential property.

At December 31, 2017, $163.7 million, or 21.2% of our total loan portfolio was secured by first liens on one-to-four-family residential loans and our home equity lines of credit totaled $25.3 million, or 3.3% of our total loan portfolio. These types of loans are generally sensitive to regional and local economic conditions that significantly impact the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. A decline in residential real estate values resulting from a downturn in the Washington housing markets in which our loans are concentrated may reduce the value of the real estate collateral securing these types of loans and increase our risk of loss if borrowers default on their loans. A decline in economic conditions or in the volume of real estate sales and/or the sales prices coupled with elevated unemployment rates may result in higher than expected loan delinquencies or problem assets, and a decline in demand for our products and services. In addition, residential loans with high combined loan-to-value ratios will be more sensitive to the fluctuation of property values than those with lower combined loan-to-value ratios and therefore may experience a higher incidence of default and severity of losses. Further, the majority of our home equity lines of credit consist of second mortgage loans. For those home equity lines secured by a second mortgage, it is unlikely that we will be successful in recovering all or a portion of our loan proceeds in the event of default unless we are prepared to repay the first mortgage loan and such repayment and the costs associated with a foreclosure are justified by the value of the property. For these reasons, we may experience higher rates of delinquencies, defaults and losses which would adversely affect our net income.

In addition, the Tax Act could negatively impact our customers because it lowers the existing caps on mortgage interest deductions and limits the state and local tax deductions. These changes could make it more difficult for borrowers to make their loan payments, could also negatively impact the housing market, which could adversely affect our business and loan growth.

Our non-owner occupied commercial real estate loans may expose us to increased credit risk.

At December 31, 2017, $32.5 million, or 4.2% of our total loan portfolio, consisted of loans secured by non-owner occupied commercial real estate properties. Loans secured by non-owner occupied properties generally expose a lender to greater risk of non-payment and loss than loans secured by owner occupied properties because repayment of such loans depend primarily on the tenant's continuing ability to pay rent to the property owner, who is our borrower, or, if the property owner is unable to find a tenant, the property owner's ability to repay the loan without the benefit of a rental income stream. Furthermore, some of our non-owner occupied commercial loan borrowers have more than one loan outstanding with us. At December 31, 2017, we had seven non-owner occupied commercial multi-loan relationships, the largest of which had a combined outstanding balance of $3.3 million, with an aggregate outstanding balance of $14.1 million. Consequently, an adverse development with respect to one credit relationship may expose us to a greater risk of loss compared to an adverse development with respect to an owner occupied commercial real estate loan.

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We occasionally purchase loans in bulk or "pools." We may experience lower yields or losses on loan pools because the assumptions we use when purchasing loans in bulk may not prove correct.

From time to time, we purchase real estate loans in bulk or "pools." When we determine the purchase price we are willing to pay to purchase loans in bulk, management makes certain assumptions about, among other things, how fast borrowers will prepay their loans, the real estate market and our ability to collect loans successfully and, if necessary, to dispose of any real estate that may be acquired through foreclosure. When we purchase loans in bulk, we perform certain due diligence procedures and we purchase the loans subject to customary limited indemnities. To the extent that our underlying assumptions prove to be inaccurate or the basis for those assumptions change (such as an unanticipated decline in the real estate market), the purchase price paid for pools of loans may prove to have been excessive, resulting in a lower yield or a loss of some or all of the loan principal. For example, if we purchase pools of loans at a premium and some of the loans are prepaid before we expected we will earn less interest income on the purchase than expected. Our success in growing through purchases of loan pools depends on our ability to price loan pools properly and on general economic conditions in the geographic areas where the underlying properties of our loans are located.

Acquiring loans through bulk purchases may involve acquiring loans of a type or in geographic areas where management may not have substantial prior experience. We may be exposed to a greater risk of loss to the extent that bulk purchases contain such loans.

Our securities portfolio may be negatively impacted by fluctuations in market value, changes in the tax code, and interest rates.

Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income and/or earnings. At December 31, 2017, the fair value of our securities portfolio was approximately $82.5 million. Factors beyond our control can significantly influence the fair value of securities in our portfolio and can cause potential adverse changes to the fair value of these securities. Changes in interest rates can have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. For example, fixed-rate securities acquired by us are generally subject to decreases in market value when interest rates rise. Additional factors include, but are not limited to, rating agency downgrades of the securities or our own analysis of the value of the security, defaults by the issuer or individual mortgagors with respect to the underlying securities, and limited investor demand. Our securities portfolio is evaluated quarterly for other-than-temporary impairment ("OTTI"). The process for determining whether impairment is other-than-temporary usually requires difficult, subjective judgments about the future financial performance of the issuer and any collateral underlying the security in order to assess the probability of receiving all contractual principal and interest payments on the security. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. We increase or decrease our shareholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. There can be no assurance that the declines in market value will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our financial condition and results of operations.

The valuation of our investment securities also is influenced by additional external market and other factors, including implementation of Securities and Exchange Commission and Financial Accounting Standards Board guidance on fair value accounting, default rates on residential mortgage securities, changes in the tax code and rating agency actions. Accordingly, there can be no assurance that future declines in the market value of our private label mortgage backed securities or other investment securities will not result in OTTI of these assets and lead to accounting charges that could have an adverse effect on our results of operations.

New lines of business or new products and services may subject us to additional risk.

From time to time, we may implement new lines of business or offer new products and services within existing lines of business. Currently, we are expanding existing commercial real estate, commercial business and residential lending programs such as home improvement loans for consumer solar projects. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services, we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives and shifting market preferences, may also impact the successful implementation of a new line of business and/or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business and/or new products or services could have a material adverse effect on our business, results of operations, and financial condition.

Our inability to manage our growth or deploy assets profitably could harm our business and decrease our overall profitability, which may cause our stock price to decline.

Our assets and deposit base have grown substantially in recent years, and we anticipate that we will continue to grow over time, perhaps significantly. To manage the expected growth of our operations and personnel, we will be required to manage multiple aspects of the business simultaneously, including among other things: (i) improve existing and implement new transaction processing, operational and financial systems, procedures and controls; (ii) maintain effective credit scoring and underwriting guidelines; (iii) maintain sufficient levels of regulatory capital; and (iv) expand our employee base and train and manage this growing employee base. In addition, to the extent we acquire other banks and or bank branches, asset pools or deposits we may have to manage additional risks such as exposure to potential asset quality issues, disruption to our normal business activities, and diversion of management's time and attention due to integration and conversion efforts. If we are unable to manage growth effectively or execute integration efforts properly, we may not be able to achieve the anticipated benefits of growth, in which our business, financial condition, and results of operations could be adversely affected.

We may not be able to sustain past levels of profitability as we grow, and our past levels of profitability should not be considered a guarantee or indicator of future success. If we are not able to maintain our levels of profitability by deploying growth in our deposits in profitable assets or investments, our net interest margin and overall level of profitability will decrease and our stock price may decline.

Hedging against interest rate exposure may adversely affect our earnings.

We employ techniques that limit, or "hedge," the adverse effects of rising interest rates on our loans held for sale, and originated interest rate locks to customers. Our hedging activity varies based on the level and volatility of interest rates and other changing market conditions. These techniques may include purchasing or selling forward contracts, purchasing put and call options on securities or securities underlying futures contracts, or entering into other mortgage-backed derivatives. There are, however, no perfect hedging strategies, and interest rate hedging may fail to protect us from loss. Moreover, hedging activities could result in losses if the event against which we hedge does not materialize. Additionally, interest rate hedging could fail to protect us or adversely affect us because, among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the party owing money in the hedging transaction may default on its obligation to pay;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction;
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value; and
- downward adjustments, or "mark-to-market losses," could reduce our stockholders' equity.

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Changes in interest rates may reduce our net interest income, and may result in higher defaults in a rising rate environment.

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve Board. In an attempt to help the overall economy, the Federal Reserve has kept interest rates low through its targeted Fed Funds rate. Beginning in December 2016, the Federal Reserve Board increased the Fed Funds rate by 100 basis points to a range of 1.25% to 1.50%. At December 31, 2017, this range was unchanged but the Federal Reserve Board has indicated a likelihood for a further increase of 25 basis points or more during 2018 subject to economic conditions. As the Federal Reserve increases the Fed Funds rate, overall interest rates will likely rise, which may negatively impact both the housing markets by reducing refinancing activity and new home purchases and the U.S. economic recovery.

Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but these changes could also affect (i) our ability to originate and/or sell loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, which could negatively impact shareholders' equity, and our ability to realize gains from the sale of such assets, (iii) our ability to obtain and retain deposits in competition with other available investment alternatives, (iv) the ability of our borrowers to repay adjustable or variable rate loans, and (v) the average duration of our investment securities portfolio and other interest-earning assets. If the interest rates paid on deposits and borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected.

Changes in interest rates could also have a negative impact on our results of operations by reducing the ability of borrowers to repay their current loan obligations or by reducing our margins and profitability. Our net interest margin is the difference between the yield we earn on our assets and the interest rate we pay for deposits and our other sources of funding. Changes in interest rates-up or down-could adversely affect our net interest margin and, as a result, our net interest income. Although the yield we earn on our assets and our funding costs tend to move in the same direction in response to changes in interest rates, one can rise or fall faster than the other, causing our net interest margin to expand or contract. Our liabilities tend to be shorter in duration than our assets, so they may adjust faster in response to changes in interest rates. As a result, when interest rates rise, our funding costs may rise faster than the yield we earn on our assets, causing our net interest margin to contract until the yields on interest-earning assets catch up.

Changes in the slope of the "yield curve", or the spread between short-term and long-term interest rates could also reduce our net interest margin. Normally, the yield curve is upward sloping, meaning short-term rates are lower than long-term rates. Because our liabilities tend to be shorter in duration than our assets, when the yield curve flattens or even inverts, we could experience pressure on our net interest margin as our cost of funds increases relative to the yield we can earn on our assets. Also, interest rate decreases can lead to increased prepayments of loans and mortgage-backed securities as borrowers refinance their loans to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk as we may have to redeploy such repayment proceeds into lower yielding investments, which would likely hurt our income.

A sustained increase in market interest rates could adversely affect our earnings. As a result of the exceptionally low interest rate environment, an increasing percentage of our deposits have been comprised of deposits bearing no or a relatively low rate of interest and having a shorter duration than our assets. At December 31, 2017, we had $108.1 million in certificates of deposit that mature within one year and $607.6 million in non-interest bearing, NOW checking, savings and money market accounts. We would incur a higher cost of funds to retain these deposits in a rising interest rate environment. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. In addition, a substantial amount of our residential mortgage loans and home equity lines of credit have adjustable interest rates. As a result, these loans may experience a higher rate of default in a rising interest rate environment. Our net income can also be reduced by the impact that changes in interest rates can have on the value of our capitalized servicing rights. At December 31, 2017, we serviced $778.9 million of loans sold to third parties, and the servicing rights associated with such loans had an amortized cost of $6.8 million and an estimated fair value, at that date, of $8.6 million. Because the estimated life and estimated income to be derived from servicing the underlying loans generally increase with rising interest rates and decrease with falling interest rates, the value of servicing rights generally increases as interest rates rise

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and decreases as interest rates fall. If interest rates fall and the value of our capitalized servicing rights decrease, we may be required to recognize an additional impairment charge against income for the amount by which amortized cost exceeds estimated fair market value.

Changes in interest rates also affect the value of our interest-earning assets and in particular our investment securities portfolio. Generally, the fair value of fixed-rate securities fluctuates inversely with changes in interest rates. Unrealized gains and losses on securities available for sale are reported as a separate component of equity, net of tax. Decreases in the fair value of securities available for sale resulting from increases in interest rates could have an adverse effect on stockholders' equity.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet or projected operating results. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management and Market Risk" of this Form 10 K.

If our non-performing assets increase, our earnings will be adversely affected.

At December 31, 2017, our non-performing assets (which consist of non-accruing loans, accruing loans 90 days or more past due, non-accrual investment securities, and OREO and other repossessed assets) were $1.0 million, or 0.1% of total assets. Our non-performing assets adversely affect our net income in various ways:

- We do not record interest income on non-accrual loans or non-performing investment securities, except on a cash basis when the collectibility of the principal is not in doubt.
- We must provide for probable loan losses through a current period charge to the provision for loan losses.
- Non-interest expense increases when we must write down the value of properties in our OREO portfolio to reflect changing market values.
- Non-interest income decreases when we must recognize other-than-temporary impairment on non-performing investment securities.
- There are legal fees associated with the resolution of problem assets, as well as carrying costs, such as taxes, insurance, and maintenance costs related to our OREO.
- The resolution of non-performing assets requires the active involvement of management, which can distract them from more profitable activity.

If additional borrowers become delinquent and do not pay their loans and we are unable to successfully manage our non-performing assets, our losses and troubled assets could increase significantly, which could have a material adverse effect on our financial condition and results of operations.

Ineffective liquidity management could adversely affect our financial results and condition.

Effective liquidity management is essential for the operation of our business. We require sufficient liquidity to meet customer loan requests, customer deposit maturities/withdrawals, payments on our debt obligations as they come due, and other cash commitments under both normal operating conditions and other unpredictable circumstances causing industry or general financial market stress. Our access to funding sources in amounts adequate to finance our activities on terms that are acceptable to us could be impaired by factors that affect us specifically, or the financial services industry or economy generally. Factors that could detrimentally impact our access to liquidity sources include a downturn in the geographic markets in which our loans and operations are concentrated or difficult credit markets. Our access to deposits may also be affected by the liquidity needs of our depositors. In particular, a majority of our liabilities are checking accounts and other liquid deposits, which are payable on demand or upon several days' notice, while by comparison, a

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substantial majority of our assets are loans, which cannot be called or sold in the same time frame. Although we have historically been able to replace maturing deposits and advances as necessary, we might not be able to replace such funds in the future, especially if a large number of our depositors seek to withdraw their accounts, regardless of the reason. A failure to maintain adequate liquidity could materially and adversely affect our business, results of operations or financial condition. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity” of this Form 10-K.

Our ability to retain bankers and recruit additional successful bankers is critical to the success of our business strategy and any failure to do so could impair our customer relationships and adversely affect our business and results of operations.

Our ability to retain and grow our loans, deposits, and fee income depends upon the business generation capabilities, reputation, and relationship management skills of our lenders. If we were to lose the services of any of our bankers, including successful bankers employed by banks that we may acquire, to a new or existing competitor, or otherwise, we may not be able to retain valuable relationships and some of our customers could choose to use the services of a competitor instead of our services.

Our success and growth strategy also depends on our continued ability to attract and retain experienced loan officers and support staff, as well as other management personnel. We may face difficulties in recruiting and retaining lenders and other personnel of our desired caliber, including as a result of competition from other financial institutions. Competition for loan officers and other personnel is strong and we may not be successful in attracting or retaining the personnel we require. In particular, many of our competitors are significantly larger with greater financial resources, and may be able to offer more attractive compensation packages and broader career opportunities. Additionally, we may incur significant expenses and expend significant time and resources on training, integration and business development before we are able to determine whether a new loan officer will be profitable or effective. If we are unable to attract and retain successful loan officers and other personnel, or if our loan officers and other personnel fail to meet our expectations in terms of customer relationships and profitability, we may be unable to execute our business strategy and our business, financial condition, results of operations, and growth prospects may be negatively affected.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. These competitors primarily include national, regional, and internet banks within the various markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, mortgage banking finance companies, brokerage firms, insurance companies, and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms, and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting), and merchant banking. A number of out-of-state financial intermediaries have opened production offices or otherwise solicit deposits in our market areas. Additionally, we face growing competition from so-called “online businesses” with few or no physical locations, including online banks, lenders and consumer and commercial lending platforms, as well as automated retirement and investment service providers. Technology has also lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints, may have lower cost structures, and due to their size, may be able to achieve economies of scale resulting in their ability to offer a broader range of products and services, as well as better pricing for those products and services than we can. Increased competition in our markets may result in reduced loans, deposits and commissions and brokers' fees, as well as reduced net interest margin and profitability. Ultimately, we may not be able to compete successfully against current and future competitors. If we are unable to attract and retain banking and mortgage customers, we may be unable to continue to grow our business, and our financial condition and results of operations may be adversely affected.

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Our ability to compete successfully depends on a number of factors including the following:

- the ability to develop, maintain, and build upon long-term customer relationships based on top-quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;
- the scope, relevance, and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations. See “Item 1. Business - Competition” of this Form 10 K.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations that are expected to increase our costs of operations.

We are currently subject to extensive examination, supervision, and comprehensive regulation by the FDIC and the DFI, primarily for the protection of depositors and the DFI. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution’s operations, reclassify assets, determine the adequacy of an institution’s allowance for loan losses, and determine the level of deposit insurance premiums assessed. These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time. The current administration has indicated that it would like to see changes made to certain financial reform regulations, including the Dodd-Frank Act, which has resulted in increased regulatory uncertainty, and we are assessing the potential impact on financial and economic markets and on our business. Changes in federal policy and at regulatory agencies are expected to occur over time through policy and personnel changes, which could lead to changes involving the level of oversight and focus on the financial services industry. The nature, timing and economic and political effects of potential changes to the current legal and regulatory framework affecting financial institutions remain highly uncertain. Any new regulations or legislation, change in existing regulations or oversight, whether a change in regulatory policy or a change in a regulator’s interpretation of a law or regulation, could have a material impact on our operations, increase our costs of regulatory compliance and of doing business, and/or otherwise adversely affect us and our profitability. Further, changes in accounting standards can be both difficult to predict and involve judgment and discretion in their interpretation by us and our independent accounting firms. These changes could materially impact, potentially even retroactively, how we report our financial condition and results of our operations as could our interpretation of those changes.

As discussed under “Business - How We Are Regulated” in Item 1 of this Form 10 K, the Dodd-Frank Act significantly changed the bank regulatory structure and affects the lending, deposit, investment, trading, and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt and implement a broad range of new rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years. It is difficult at this time to predict when or how any new standards will ultimately be applied to us or what specific impact the Dodd-Frank Act and the rules and regulations for implementation (some of which have yet to be written) will have on community banks. However, it is expected that at a minimum, they will increase our operating and compliance costs and will increase our non-interest expense.

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