First Financial Northwest, Inc.
Form 10-K
March 14, 2013

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

FORM 10-K

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

For the Fiscal Year Ended December 31, 2012

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

Commission File Number: 000-33652

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

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

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

Common Stock, $0.01 par value per share	The Nasdaq Stock Market LLC
(Title of Each Class)	(Name of Each Exchange on Which Registered)

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

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

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ____

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

Large accelerated filer Accelerated filer X Non-accelerated filer Smaller reporting company ____

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

The aggregate market value of the Common Stock outstanding held by nonaffiliates of the Registrant based on the closing sales price of the Registrant's Common Stock as quoted on The Nasdaq Stock Market LLC on June 30, 2012 was $148,097,651 (18,238,627) shares at $8.12 per share. For purposes of this calculation, common stock held only by executive officers and directors of the Registrant is considered to be held by affiliates. As of March 2, 2013, the Registrant had outstanding 18,805,168 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Registrant's Definitive Proxy Statement for the 2013 Annual Meeting of Shareholders (Part III).

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Forward-Looking Statements
Certain matters discussed in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words “believes,” “expects,” “anticipates,” “estimates,” “forecasts,” “intends,” “plans,” “targets,” “potentially,” “probably,” “projects,” “outlook” or similar expressions or future or co verbs such as “may,” “will,” “should,” “would” and “could.” Forward-looking statements include statements with respect to ou beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs, that may be affected by deterioration in the housing and commercial real estate markets, and may lead to increased losses and nonperforming assets in our loan portfolio, or result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve Bank of San Francisco (“Federal Reserve”) and our bank subsidiary by the Federal Deposit Insurance Corporation (“FDIC”), the Washington State Department of Financial Institutions, Division of Banks (“DFI”) or other regulatory authorities, including the possibility that any such regulatory authority may initiate additional enforcement actions against the Company or the Bank to take additional corrective action and refrain from unsafe and unsound practices which also may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; our compliance with regulatory enforcement actions, including the requirements and restrictions that have been imposed upon First Financial Northwest under the memorandum of understanding with the Federal Reserve and the memorandum of understanding the Bank entered into with the FDIC and the DFI and the possibility that First Financial Northwest and the Bank will be unable to fully comply with these informal enforcement actions which could result in the imposition of additional requirements or restrictions; our ability to pay dividends on our common stock; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining the fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial services companies; our ability to reduce our noninterest expenses; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") and the implementing regulations; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial

Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in this Form 10-K and our other reports filed with the U.S. Securities and Exchange Commission ("SEC"). Any of the forward-looking statements that we make in this Form 10-K and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

As used throughout this report, the terms "we", "our", or "us" refer to First Financial Northwest, Inc. and our consolidated subsidiaries, including First Savings Bank Northwest and First Financial Diversified Corporation.

Internet Website

We maintain a website with the address www.fsbnw.com. The information contained on our website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own Internet access charges, we make available free of charge through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports, on our investor information page. These reports are posted as soon as reasonably practicable after they are electronically filed with the SEC. All of our SEC filings are also available free of charge at the SEC's website at www.sec.gov or by calling the SEC at 1-800-SEC-0330.

PART I

Item 1. Business

General

First Financial Northwest, Inc. (“First Financial Northwest” or “the Company”), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest (“First Savings Bank” or “the Bank”) in connection with the conversion from a mutual holding company structure to a stock holding company structure completed on October 9, 2007. At December 31, 2012, we had total assets of $942.7 million, net loans of $650.5 million, deposits of $665.8 million and stockholders’ equity of $187.1 million. First Financial Northwest’s business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to First Savings Bank.

First Savings Bank was organized in 1923 as a Washington state-chartered savings and loan association, converted to a federal mutual savings and loan association in 1935 and converted to a Washington state-chartered mutual savings bank in 1992. In 2002, First Savings Bank reorganized into a two-tier mutual holding company structure, became a stock savings bank and became the wholly-owned subsidiary of First Financial of Renton, Inc. In connection with the conversion, First Savings Bank changed its name to “First Savings Bank Northwest.”

First Financial Northwest is a savings and loan holding company and is subject to regulation by the Federal Reserve Bank of San Francisco ("Federal Reserve") as the successor to the Office of Thrift Supervision (“OTS”) in the oversight and regulation of savings and loan holding companies. First Savings Bank is examined and regulated by the Washington State Department of Financial Institutions (“DFI”) and by the Federal Deposit Insurance Corporation (“FDIC”). First Savings Bank is required to have certain reserves set by the Board of Governors of the Federal Reserve System and is a member of the Federal Home Loan Bank of Seattle (“FHLB”), which is one of the 12 regional banks in the Federal Home Loan Bank System (“FHLB System”).

First Savings Bank is a community-based savings bank primarily serving the Puget Sound Region, which consists primarily of King and, to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington through our full-service banking office located in Renton, Washington. First Savings Bank’s business consists of attracting deposits from the public and utilizing these funds to originate one-to-four family residential, multifamily, commercial real estate, construction/land development, business and consumer loans. Our current business strategy includes an emphasis on one-to-four family residential, multifamily and commercial real estate lending.

At December 31, 2012, $307.0 million, or 45.6% of our total loan portfolio was comprised of one-to-four family residential loans; multifamily loans were $111.5 million, or 16.5%; commercial real estate loans were $221.9 million, or 32.9%; construction/land development loans were $19.4 million, or 2.9%; and business and consumer loans were $3.0 million and $11.1 million, or 0.4% and 1.7%, respectively. Included in our one-to-four family residential, multifamily, commercial real estate and construction/land development portfolios at December 31, 2012, were $57.5 million, $3.4 million, $20.1 million and $4.6 million of total loans, respectively, to our five largest borrowing relationships.

The principal executive office of First Savings Bank is located at 201 Wells Avenue South, Renton, Washington, 98057; our telephone number is (425) 255-4400.

Regulatory Actions

On April 14, 2010, the OTS and members of the Board of Directors of First Financial Northwest entered into an informal supervisory agreement or Memorandum of Understanding ("MOU"), which is now enforced by the Federal Reserve, the successor to the OTS as a regulator of the holding company. Under the terms of the MOU, the Company agreed, among other things, to provide notice to and obtain a written non-objection from the Federal Reserve prior to the Company (a) declaring a dividend or redeeming any capital stock and (b) incurring, issuing, renewing or repurchasing any new debt.

On March 27, 2012, the Bank's regulators, the FDIC and the DFI, terminated the Consent Order ("Order") which became effective on September 24, 2010. In place of the Order, the Bank entered into an MOU, which is an informal regulatory action, with the FDIC and the DFI. The Order was terminated as a result of the steps the Bank took in complying with the Order, including reducing its level of classified assets, increasing earnings, augmenting management and improving the overall condition of the Bank.

The MOU with the Bank contains provisions concerning the management and directors of the Bank, interest rate risk, minimum capital levels, the allowance for loan and lease losses ("ALLL"), lending and collection policies, policies concerning the Bank and its affiliates, restrictions on paying dividends and a requirement to furnish progress reports to the FDIC and the DFI.

A copy of the MOU with the Bank is attached to the Form 8-K that was filed with the SEC on April 2, 2012. The MOUs will remain in effect until modified or terminated by the FDIC and the DFI in the case of the Bank and the Federal Reserve with respect to the Company. For more information regarding the MOUs and their impact on First Financial Northwest and the Bank, see Item 1A. "Risk Factors - Certain regulatory restrictions are imposed on us; lack of compliance could result in monetary penalties and/or additional regulatory actions."

Proxy Contest and Related Litigation

On March 29, 2012, Stilwell Value Partners II, L.P., one of a group of funds controlled by Joseph Stilwell (the “Stilwell Group”), submitted to First Financial Northwest a notice of the Stilwell Group's intent to nominate Joseph Stilwell and Spencer L. Schneider for election to the Company's Board of Directors at the Company's May 24, 2012 Annual Meeting of Shareholders (“Annual Meeting”). The Federal Reserve subsequently advised the Stilwell Group that the solicitation of proxies to elect two directors to the Company's Board of Directors, along with other actions the Stilwell Group had taken in connection with the proxy contest, could result in a controlling interest that would not be permitted under federal law. As a result, the Stilwell Group determined to nominate only Mr. Schneider for election to the Company's Board of Directors at the Annual Meeting.

Following the Annual Meeting, the independent inspector of election, Raymond Riley of Carl T. Hagberg and Associates (“Inspector of Election”), issued his Final Report which stated that (1) a quorum was present for the transaction of business at the Annual Meeting; and (2) the opposition proxy holders did not submit an executed master ballot for the Stilwell Group's nominee prior to the closing of the polls. Thus, the Company's nominees, Victor Karpiak, M. Scott Gaspard and Daniel L. Stevens, were each duly elected to serve for a three year term; the Stilwell Group's nominee did not receive the votes required for election to the Company's Board of Directors.

On June 7, 2012, the Stilwell Group filed a lawsuit in the Superior Court of the State of Washington for King County (the "Court") against First Financial Northwest, Raymond Riley (the independent Inspector of Election) and Victor Karpiak, seeking to overturn the outcome of the election of directors at the Annual Meeting. The Stilwell Group's complaint alleged, among other things, that (i) proxy cards and proxy reporting service tabulations showed that the Stilwell Group's nominee, Spencer L. Schneider, received more shareholder support than Mr. Karpiak; (ii) the Inspector of Election should have determined the outcome of the election based on proxy cards and proxy reporting service tabulations alone and that submission of a master ballot by the opposition proxy holders was unnecessary; (iii) alternatively, the opposition group's master ballot should have been accepted late, after the polls had been declared closed; and (iv) if the absence of a timely master ballot means shareholders that returned proxies to the Stilwell Group did not vote, then those shareholders were not present for quorum purposes either, and the election was invalid for lack of a quorum. The Company denied all of the Stilwell Group's allegations.

On October 5, 2012, the Court heard oral argument concerning a motion for summary judgment filed by the Stilwell Group and the cross-motions for summary judgment filed by (1) First Financial Northwest and Victor Karpiak and (2) Raymond J. Riley (collectively, the "Defendants”).

On October 9, 2012, the Court issued an order in which it denied the Stilwell Group's motion for summary judgment and granted in part the Defendants' cross-motions. The Court agreed with the Defendants that the Inspector of Election correctly determined that the Stilwell Group did not cast a ballot before the time to vote had closed. The Court concluded, however, that certain material facts were in dispute that precluded it from ruling as a matter of law on whether the Inspector of Election correctly determined that he could not accept a master ballot that the Stilwell Group submitted after the polls had closed. The determination of this factual dispute was to have taken place at an evidentiary hearing in January 2013.

In December 2012, First Financial Northwest and the Stilwell Group announced that a settlement of the case was reached. In connection with the settlement, the Company entered into a Settlement Agreement and Mutual Releases on December 20, 2012, as amended on January 16, 2013 and February 26, 2013, with the Stilwell Group. The original Settlement Agreement provided, among other things, that (i) Spencer L. Schneider will be given a seat on the Company's Board after the Company and Mr. Schneider obtain any required regulatory approvals, and will then be nominated by the Company at the 2013 Annual Meeting of Shareholders for a full three-year term; (ii) Victor Karpiak will resign as Chairman of the Board immediately after Mr. Schneider joins the Board, but Mr. Karpiak will remain a member of the Board until September 1, 2013, whereupon he will resign from the Board; (iii) the Company will reimburse a portion of the Stilwell Group's proxy solicitation expenses in connection with the 2012 Annual Meeting; (iv) the Stilwell Group will support the Board's nominees in the director elections to be held at the Company's 2013, 2014 and 2015 Annual Meetings of Shareholders; and (v) the litigation will be dismissed with mutual releases exchanged.

Pursuant to the first amendment to the Settlement Agreement, the Company will appoint Kevin D. Padrick to its Board, rather than Mr. Schneider, subject to any required regulatory approvals, and will then nominate Mr. Padrick at the 2013 Annual Meeting of Shareholders for a full three-year term. Mr. Padrick is a Senior Principal of Obsidian Finance Group, LLC, whose offices are located in Lake Oswego, Oregon. The second amendment to the Settlement Agreement extended the time to allow for receipt of the required regulatory approvals. All other significant terms of the settlement remain the same.

For more information regarding the settlement, please see the Company's Form 8-Ks that were filed with the SEC on December 19, 2012, January 17, 2013 and February 26, 2013.

Currently, the amount or range of reasonably possible expenses related to the proxy contest litigation cannot be estimated.

Market Area

We consider our primary market area to be the Puget Sound Region, which consists primarily of King and, to a lesser extent, Pierce, Snohomish and Kitsap counties. During 2012, the economies of King, Pierce, Snohomish and Kitsap counties continued to experience challenges though certain economic conditions showed signs of improvement. During 2012, home prices in the region experienced their first gains since 2006 even though significant foreclosure and short sale activity continued in the region. In addition, labor trends were positive as each county's unemployment rate declined during 2012.

King County has the largest population of any county in the state of Washington, covering approximately 2,100 square miles. It has a population of approximately 1.9 million residents and a median household income of approximately $66,000, according to the 2010 U.S. Census projection. King County has a diversified economic base with many nationally recognized firms including Boeing, Microsoft, Paccar, Starbucks, Costco and Amazon. According to the Washington State Employment Security Department, the unemployment rate for King County was 6.1% at December 31, 2012, compared to 7.1% at December 31, 2011 and the national average of 7.8% at December 31, 2012. The median sales price of a residential home in King County was $327,000 during 2012, a 4.9% increase compared to 2011, according to the Northwest Multiple Listing Service ("MLS"). Residential sales volumes increased 19.9% in 2012 as compared to 2011 and inventory levels at December 31, 2012 are projected to be 1.8 months according to the MLS.

Pierce County has the second largest population of any county in the state of Washington, covering approximately 1,800 square miles. It has approximately 795,000 residents and a median household income of approximately $56,000, according to the 2010 U.S. Census projection. The Pierce County economy is diversified with the presence of military-related government employment (Joint Base Lewis-McChord), transportation and shipping employment (Port of Tacoma) and aerospace-related employment (Boeing). According to the Washington State Employment Security Department, the unemployment rate for Pierce County was 8.5% in December 2012, compared to 9.3% at year-end 2011. The median sales price of a residential home in Pierce County was $190,000 during 2012, unchanged compared to 2011, according to the MLS. Residential sales volumes increased by 5.1% in 2012 as compared to 2011 and inventory levels at December 31, 2012 are projected to be 2.8 months according to the MLS.

Snohomish County has the third largest population of any county in the state of Washington, covering approximately 2,090 square miles. It has approximately 713,000 residents and a median household income of approximately $63,000, according to the 2010 U.S. Census projection. The economy of Snohomish County is diversified with the presence of military-related government employment (Everett Homeport Naval Base), aerospace-related employment (Boeing) and retail trade. According to the Washington State Employment Security Department, the unemployment rate for Snohomish County decreased to 6.7% in December 2012 from 8.0% in December 2011. The median sales price of a residential home in Snohomish County was $245,000 during 2012, a 6.5% increase compared to 2011, according to the MLS. Residential sales volumes increased by 14.1% in 2012 as compared to 2011, and inventory levels at December 31, 2012 are projected to be 1.7 months according to the MLS.

Kitsap County has the seventh largest population of any county in the state of Washington, covering approximately 570 square miles. It has approximately 251,000 residents and a median household income of approximately $55,000, according to the 2010 U.S. Census projection. The Kitsap County economy is diversified with the presence of military-related government employment (Naval Base Kitsap, Puget Sound Naval Shipyard), health care, retail and education. According to the Washington State Employment Security Department, the unemployment rate for Kitsap County decreased to 7.0% in December 2012 from 7.6% in December 2011. The median sales price of a residential home in Kitsap County was $230,000 during 2012, a 1.3% decrease compared to 2011, according to the MLS. Residential sales volumes increased by 14.7% in 2012 as compared to 2011 and inventory levels at December 31, 2012 are projected to be 4.4 months according to the MLS.

For a discussion regarding the competition in our primary market area, see "- Competition."

Lending Activities

General. We focus our lending activities primarily on loans secured by first mortgages on one-to-four family residences, multifamily and commercial real estate, construction/land development and business lending. We offer a limited variety of consumer secured loans as an accommodation to our customers, including savings account loans and home equity loans, which include lines of credit and second mortgage loans. As of December 31, 2012, our net loan portfolio totaled $650.5 million and represented 69.0% of our total assets.

Our current loan policy generally limits the maximum amount of loans we can make to one borrower to the lesser of 15% of the Bank's total risk-based capital or $20 million. Exceptions may be made to this policy with the prior approval of the Board of Directors if the borrower exhibits financial strength or compensating factors that sufficiently offset any exceptions and are based on the loan-to-value ratio, borrower's financial condition, net worth, credit history, earnings capacity, installment obligations and current payment history up to the regulatory limit of 20% of total risk-based capital.

The five largest lending relationships as of December 31, 2012 in descending order were:

Borrower [1]	Aggregate Balance of Loans at December 31, 2012 [2] (Dollars in thousands)		Number of Loans
Real estate builder	$25,246		96
Real estate investor	18,071		3
Real estate builder	14,756	(3)	92
Real estate investor	13,881		34
Real estate builder	13,652	(4)	73
Total	$85,606		298

(1) The composition of borrowers represented in the table may change between periods.
(2) Net of loans in process ("LIP").
(3) Of this amount, $13.1 million were considered impaired loans, all of which were performing one-to-four-family residential loans.
(4) Of this amount, $12.8 million were considered impaired loans, of which $12.0 million were performing one-to-four family residential loans and $809,000 were restructured loans which were performing commercial real estate loans.

During 2012, we continued to decrease loan concentration levels in our five largest lending relationships. At December 31, 2012, loans to our five largest lending relationships totaled $85.6 million compared to $96.9 million at December 31, 2011, a decrease of $11.3 million, or 11.7%. In addition, we continue to have only one loan relationship that exceeded our current loan policy limit to one borrower at December 31, 2012 and December 31, 2011. The loans to this borrower were originated in past years prior to our existing policy limits.

The following table details the breakdown of the types of loans to our top five lending relationships at December 31, 2012.

Borrower [1]	One-to-Four Family Residential (Rental Properties) (In thousands)	Multifamily	Commercial Real Estate (Rental Properties)	Construction/Land Development	Aggregate Balance of Loans [2]
Real estate builder	$20,553	$—	$97	$ 4,596	$25,246
Real estate investor	—	—	18,071	—	18,071
Real estate builder [3]	14,531	—	225	—	14,756
Real estate investor	9,593	3,358	930	—	13,881
Real estate builder [4]	12,843	—	809	—	13,652
Total	$57,520	$3,358	$20,132	$ 4,596	$85,606

(1) The composition of borrowers represented in the table may change between periods.

(2) Net of LIP.

(3) Of this amount, $13.1 million were considered impaired loans, all of which were performing one-to-four family residential loans.

(4) Of this amount, $12.8 million were considered impaired loans, of which $12.0 million were performing one-to-four family residential loans and $809,000 were restructured loans which were performing commercial real estate loans.

Some of the builders listed in the above tables, as part of their previous business strategy, retained a certain percentage of their finished homes in their own inventory of permanent investment properties, (i.e. one-to-four family rental properties). In the past, these properties were used to enhance the builders' liquidity through rental income and improve their long-term equity position through the appreciation in market value of the properties. Due to the continued, prolonged depressed housing market and the challenging local economy, this business strategy was not sustainable for these builders. As a result, we have incurred losses related to these builders and have significantly reduced our exposure to these builders over the past few years. We continue to work with these builders to further reduce our exposure. For the three builders included in the previous table, total one-to-four family rental properties decreased $400,000, or 0.08% to $47.9 million at December 31, 2012 from $48.3 million at December 31, 2011. These builders have been, and at December 31, 2012 were, in compliance with the repayment terms of their respective restructured loans. The real estate investors listed in the table above have been in compliance with the original terms of their respective loans.

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

	December 31,									
	2012		2011		2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
One-to-four family residential: (1)										
Permanent	$306,851	45.5 %	$335,412	46.4 %	$393,334	44.1 %	$481,046	43.1 %	$499,562	43.9 %
Construction	177	0.1	—	—	5,356	0.6	15,685	1.4	12,884	1.2
	307,028	45.6	335,412	46.4	398,690	44.7	496,731	44.5	512,446	45.1
Multifamily: (2)										
Permanent	105,936	15.7	110,148	15.2	140,762	15.8	128,943	11.5	99,790	8.8
Construction	5,585	0.8	3,526	0.5	4,114	0.5	17,565	1.6	1,150	0.1
	111,521	16.5	113,674	15.7	144,876	16.3	146,508	13.1	100,940	8.9
Commercial real estate: (2)										
Permanent	207,436	30.8	218,032	30.2	237,708	26.6	251,185	22.5	223,360	19.6
Construction	12,500	1.8	12,500	1.7	28,362	3.2	31,605	2.8	28,876	2.5
Land	1,942	0.3	1,811	0.2	6,643	0.7	6,206	0.6	8,491	0.8
	221,878	32.9	232,343	32.1	272,713	30.5	288,996	25.9	260,727	22.9
Construction/land development: (2)										
One-to-four family residential	608	0.1	6,194	0.9	26,848	3.0	95,699	8.6	145,329	12.8
Multifamily	8,375	1.2	855	0.1	1,283	0.1	3,624	0.3	13,322	1.2
Commercial real estate	—	—	1,104	0.2	1,108	0.1	1,129	0.1	1,324	0.1
Land development	10,435	1.6	16,990	2.3	27,262	3.1	63,501	5.7	90,537	7.9
	19,418	2.9	25,143	3.5	56,501	6.3	163,953	14.7	250,512	22.0
Business	2,968	0.4	3,909	0.6	479	0.1	353	0.1	—	—
Consumer	11,110	1.7	12,499	1.7	19,127	2.1	18,678	1.7	12,927	1.1
Total loans	673,923	100.0%	722,980	100.0%	892,386	100.0%	1,115,219	100.0%	1,137,552	100.0%
Less:										
LIP	8,856		1,372		10,975		39,942		82,541	
Deferred loan fees, net	2,057		1,761		2,421		2,938		2,848	
ALLL	12,542		16,559		22,534		33,039		16,982	
Loans receivable, net	$650,468		$703,288		$856,456		$1,039,300		$1,035,181	

(1) Includes $139.8 million and $147.4 million of non-owner occupied loans at December 31, 2012 and 2011, respectively.

(2) We do not include construction loans that will convert to permanent loans in the construction/land development category. We consider these loans to be “rollovers” in that one loan is originated for both the construction loan and permanent financing. These loans are classified according to the underlying collateral. As a result, at December 31, 2012, we had $12.5 million, or 5.6% of our total commercial real estate portfolio, $5.6 million, or 5.0% of our total multifamily loan portfolio and $177,000, or 0.1% of our total one-to-four family residential loan portfolio in these

“rollover” type of loans. At December 31, 2011, we had $12.5 million, or 5.4% of our total commercial real estate portfolio and $3.5 million, or 3.1% of our total multifamily loan portfolio in these "rollover" type of loans. At December 31, 2012 and 2011, $1.9 million and $1.8 million, respectively, of commercial real estate land loans were not included in the construction/land development category because we classify raw land or buildable lots where we do not intend to finance the construction as commercial real estate land loans.

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

	December 31,									
	2012		2011		2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
FIXED-RATE LOANS	(Dollars in thousands)									
Real estate:										
One-to-four family residential	$263,503	39.1 %	$297,769	41.2 %	$359,675	40.3 %	$482,531	43.3 %	$506,288	44.5 %
Multifamily	94,327	14.0	105,420	14.6	140,210	15.7	128,561	11.5	99,510	8.8
Commercial real estate	193,476	28.7	208,418	28.8	235,947	26.4	270,604	24.3	245,447	21.6
Construction/land development	3,962	0.6	—	—	556	0.1	9,701	0.9	20,689	1.8
Total real estate	555,268	82.4	611,607	84.6	736,388	82.5	891,397	80.0	871,934	76.7
Business	943	0.1	1,355	0.2	124	—	150	—	—	—
Consumer	1,084	0.2	1,171	0.1	3,743	0.4	3,561	0.3	3,488	0.3
Total fixed-rate loans	557,295	82.7	614,133	84.9	740,255	82.9	895,108	80.3	875,422	77.0
ADJUSTABLE-RATE LOANS										
Real estate:										
One-to-four family residential	43,525	6.5	37,643	5.2	39,015	4.4	14,200	1.3	6,158	0.6
Multifamily	17,194	2.5	8,254	1.1	4,666	0.5	17,947	1.6	1,430	0.1
Commercial real estate	28,402	4.2	23,925	3.3	36,766	4.1	18,392	1.6	15,280	1.3
Construction/land development	15,456	2.3	25,143	3.5	55,945	6.3	154,252	13.8	229,823	20.2
Total real estate	104,577	15.5	94,965	13.1	136,392	15.3	204,791	18.3	252,691	22.2
Business	2,025	0.3	2,554	0.4	355	0.1	203	—	—	—
Consumer	10,026	1.5	11,328	1.6	15,384	1.7	15,117	1.4	9,439	0.8
Total adjustable-rate loans	116,628	17.3	108,847	15.1	152,131	17.1	220,111	19.7	262,130	23.0
Total loans	673,923	100.0%	722,980	100.0%	892,386	100.0%	1,115,219	100.0%	1,137,552	100.0%
Less:										
LIP	8,856		1,372		10,975		39,942		82,541	
Deferred loan fees, net	2,057		1,761		2,421		2,938		2,848	
ALLL	12,542		16,559		22,534		33,039		16,982	
Loans receivable, net	$650,468		$703,288		$856,456		$1,039,300		$1,035,181	

One-to-Four Family Residential Real Estate Lending. As of December 31, 2012, $307.0 million, or 45.6% of our total loan portfolio consisted of permanent loans secured by one-to-four family residences.

First Savings Bank is a traditional fixed-rate portfolio lender when it comes to financing residential home loans. In 2012, we originated $24.6 million in one-to-four family residential loans, most of which had fixed-rates and fixed terms. Approximately 50% of our one-to-four family residential loan originations in 2012 were in connection with the refinance of an existing loan. New loan originations comprised the remaining 50%. At December 31, 2012, $167.2 million, or 54.5% of our one-to-four family residential portfolio consisted of owner occupied loans with $139.8 million, or 45.5% consisting of non-owner occupied loans. In addition, at December 31, 2012, $263.5 million, or 85.8% of our one-to-four family residential loan portfolio consisted of fixed-rate loans. Substantially all of our one-to-four family residential loans require both monthly principal and interest payments.

We also originate a limited number of jumbo loans that we retain in our portfolio. Loans originated with balances greater than $417,000 are generally considered jumbo except those originated in King, Pierce and Snohomish counties where the threshold for purchase by Freddie Mac and Fannie Mae is $506,000. One-to-four family residential loans classified as jumbo loans totaled $56.1 million and consisted of 79 loans at December 31, 2012. The loans in this portfolio have been priced at rates of 0.125% to 1.00% higher than the standard rates quoted on conventional loans. As of December 31, 2012, two of our jumbo loans totaling $877,000 were over 90 days past due, one jumbo loan for $614,000 was past due over 60 days but less than 90 days and three jumbo loans for $2.1 million were past due 30 to 60 days. The remaining jumbo loans in this loan portfolio were performing in accordance with their loan repayment terms at December 31, 2012. Charged-off, one-to-four family residential loans totaled $2.2 million for the year ended December 31, 2012, of which $553,000 were jumbo loans. For the years ended December 31, 2011 and 2010, charged-off one-to-four family residential loans totaled $2.3 million and $24.6 million, of which $833,000 and $4.4 million were jumbo loans, respectively.

Our fixed-rate, one-to-four family residential loans are generally originated with 15 to 30 year terms, although such loans typically remain outstanding for substantially shorter periods, particularly in a declining interest rate environment. In addition, substantially all of our one-to-four family residential loans contain due-on-sale clauses providing that we may declare the unpaid amount due and payable upon the sale of the property securing the loan. Typically, we enforce these due-on-sale clauses to the extent permitted by law and as a standard course of business. The average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates payable on outstanding loans.

Our lending policy generally limits the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 90% of the lesser of the appraised value or the purchase price. The maximum loan-to-value ratio on one-to-four family loans secured by non-owner occupied properties is generally 80% with exceptions requiring Loan Committee approval. Properties securing our one-to-four family residential loans are appraised by independent appraisers approved by us. We require the borrowers to obtain title, hazard and, if necessary, flood insurance. We generally do not require earthquake insurance because of competitive market factors.

Our construction loans to individuals to build their personal residences typically are structured to be converted to fixed-rate permanent loans at the end of the construction phase with one closing for both the construction loan and the permanent financing. Prior to making a commitment to fund a construction loan, we require an appraisal of the post construction value of the project by an independent appraiser. During the construction phase, which typically lasts 12 to 18 months, an approved inspector or our designated loan officer makes periodic inspections of the construction site and loan proceeds are disbursed directly to the contractor or borrower as construction progresses. Typically, disbursements are made in monthly draws during the construction period. Construction loans require interest-only payments during the construction phase and are structured to be converted to fixed-rate permanent loans at the end of the construction phase. At December 31, 2012, there was one owner-occupied construction loan for $177,000 with LIP of $95,000 in the one-to-four family residential loan balance.

Loans secured by rental properties represent a unique credit risk to us and, as a result, we adhere to more stringent underwriting guidelines. Of primary concern in non-owner occupied real estate lending is the consistency of rental income of the property. Payments on loans secured by rental properties depend primarily on the tenants 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. In addition, successful operation and management of non-owner occupied properties, including property maintenance standards, may affect repayment. As a result, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. We generally require borrowers and loan guarantors, if any, to provide annual financial statements and we consider and review a rental income cash flow analysis of the borrower as well as the net operating income of the property, the borrower’s expertise, credit history and profitability and the value of the underlying property. These loans are generally secured by a first mortgage on the underlying collateral property along with an assignment of rents and leases. If the borrower has multiple loans for rental properties with us, the loans are typically not cross-collateralized.

At December 31, 2012, $6.2 million of our one-to-four family residential loans were delinquent in excess of 90 days and/or in nonaccrual status.

Multifamily and Commercial Real Estate Lending. As of December 31, 2012, $111.5 million, or 16.5% of our total loan portfolio was secured by multifamily real estate and $221.9 million, or 32.9% of our loan portfolio was secured by commercial real estate properties. Our commercial real estate loans are typically secured by office and medical buildings, retail shopping centers, mini-storage facilities, industrial use buildings and warehouses. Substantially all of our multifamily and commercial real estate loans are secured by properties located in our primary market area. Commercial real estate loans are subject to underwriting standards and processes similar to those of multifamily loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate.

Typically, multifamily and commercial real estate loans have higher balances, are more complex to evaluate and monitor and involve a greater degree of risk than one-to-four-family residential loans. In an attempt to mitigate this risk, these loans are generally priced at a higher rate of interest than one-to-four family residential loans and generally have a maximum loan-to-value ratio of 75% of the lesser of the appraised value or purchase price for multifamily and 70% for commercial real estate. We generally require and obtain loan guarantees from financially capable parties based upon the review of personal financial statements. If the borrower is a corporation or partnership, we generally require and obtain personal guarantees from the principals based upon a review of their personal financial statements and individual credit reports.

The average loan size in our multifamily and commercial real estate loan portfolios was $739,000 and $1.1 million, respectively, as of December 31, 2012. We currently target individual multifamily and commercial real estate loans between $1.0 million and $5.0 million; however, we can by policy originate loans to one borrower up to 15% of the Bank’s total risk-based capital. The largest multifamily loan as of December 31, 2012 was a 96-unit apartment complex with a net outstanding principal balance of $4.7 million located in Kitsap County. As of December 31, 2012, the largest commercial real estate loan had a net outstanding balance of $12.5 million and was secured by a self-storage facility located in King County. At that date, these two loans were performing according to their respective loan repayment terms.

We also make construction loans for commercial development projects. The projects include multifamily, retail, office/warehouse and office buildings. These loans generally have an interest-only payment phase during construction and generally convert to permanent financing when construction is complete. Disbursement of funds is at our sole discretion and is based on the progress of construction. Generally the maximum loan-to-value ratio applicable to these loans is 75% of the appraised post-construction value. At December 31, 2012, multifamily and commercial real estate "rollover" construction loans amounted to $18.1 million, or 5.4% of the combined multifamily and commercial real estate loan portfolio.

The credit risk related to multifamily and commercial real estate loans is considered to be greater than the risk related to one-to-four family residential loans because the repayment of multifamily and commercial real estate loans typically is dependent on the income stream from the real estate securing the loan as collateral and the successful operation of the borrower’s business, which can be significantly affected by adverse conditions in the real estate markets or in the economy, generally. For example, if the cash flow from the borrower’s project is reduced due to leases not being obtained or renewed, the borrower’s ability to repay the loan may be impaired. In addition, many of our multifamily and commercial real estate loans are not fully amortizing and contain large balloon payments upon maturity. These balloon payments may require the borrower to either sell or refinance the underlying property in order to make the balloon payment.

If we foreclose on a multifamily or commercial real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential mortgage loans because there are fewer potential purchasers of the collateral. Our multifamily and commercial real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment in the collectability of our multifamily or commercial real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios. Multifamily loans totaling $4.7 million were delinquent in excess of 90 days and/or classified in nonaccrual status and commercial real estate loans totaling $6.3 million were 90 days or more delinquent and/or in nonaccrual status at December 31, 2012. Commercial real estate loans totaling $6.1 million were charged-off during the year ended December 31, 2012 as compared to $4.2 million and $8.0 million for the years ended December 31, 2011 and 2010, respectively. Multifamily loans totaling $153,000 and $125,000 were charged-off during the years ended December 31, 2012 and 2011, respectively. There were no multifamily loans charged-off during the year ended December 31, 2010.

Construction/Land Development Loans. We originate construction/land development loans to residential builders for the construction of single-family residences, condominiums, townhouses and residential developments located in our market area. Our land development loans are generally made to builders intending to develop lots. Construction/land development loans to builders generally require the borrower to have had an existing relationship with us and have a proven record of successful projects.

At December 31, 2012, our total construction/land development loans amounted to $19.4 million, or 2.9% of our total loan portfolio. At December 31, 2012, our one-to-four family residential construction loans and land development loans to builders amounted to $608,000 and $10.4 million, respectively. In addition to loan repayments and charge-offs, the $5.7 million decrease in our construction/land development portfolio from December 31, 2011 to December 31, 2012 was the result of our concerted efforts working with our construction loan borrowers when possible to bring the loan payment current or restructure their loans, and when this option was not feasible, to proceed with foreclosure or deed-in-lieu of foreclosure proceedings to transfer the underlying property to other real estate owned ("OREO"). Construction/land development loans classified as nonperforming totaled $4.8 million at December 31, 2012. At that date there were no LIP related to our nonperforming construction/land development loans and $6.9 million in LIP related to our performing construction/land development loans.

At the dates indicated, the composition of our total construction/land development loan portfolio and the related nonperforming loans in this portfolio were as follows:

	December 31, Total Loans		Nonperforming loans	
	2012	2011	2012	2011
	(In thousands)			
One-to-four family residential:				
Construction speculative	$608	$6,194	$—	$756
Multifamily:				
Construction speculative	8,375	855	805	855
Commercial real estate:				
Construction speculative	—	1,104	—	—
Land development	10,435	16,990	3,962	7,588
Total construction/land development [1][2]	$19,418	$25,143	$4,767	$9,199

[1] LIP for construction/land development loans at December 31, 2012 and 2011 were $6.9 million and $420,000, respectively. There were no LIP for nonperforming construction/land development loans at December 31, 2012 and 2011.
[2] We do not include construction loans that will convert to permanent loans in the construction/land development category. We consider these loans to be "rollovers" in that one loan is originated for both the construction loan and permanent financing. These loans are classified according to the underlying collateral. As a result, at December 31, 2012, we had $177,000, or 0.1% of our total one-to-four family residential loan portfolio, $12.5 million, or 5.6% of our total commercial real estate portfolio and $5.6 million, or 5.0% of our total multifamily loan portfolio in these "rollover" type of loans.

Multifamily construction speculative loans, including LIP, increased $7.5 million to $8.4 million at December 31, 2012 from $855,000 at December 31, 2011. The increase was mainly attributable to two "micro apartment" loans both located in King County. After the projects are completed, including a lease up period, and provided the loans are performing, these loans will be refinanced at then current interest rates into permanent loans with us or another lender.

The following table includes construction/land development loans by county at December 31, 2012:

County	Loan Balance [1]	Percent of Loan Balance	
	(Dollars in thousands)		
King	$5,695	45.4	%
Thurston	1,188	9.5	
Whatcom [2]	3,962	31.6	
All other	1,687	13.5	
Total	$12,532	100.0	%

(1) Net of LIP.

(2) Represents one loan that was originated in 2007 which was in a workout program and was purchased through a receivership in March 2012.

Loans to finance the construction of single-family homes and subdivisions and land development loans are generally offered to builders in our primary market areas. Many of these loans are termed "speculative" because the builder does not have, at the time of loan origination, a signed contract with a buyer for the home or lot who has a commitment for permanent financing with either us or another lender The buyer may be identified either during or after the construction period, with the risk that the builder will have to fund the debt service on the speculative loan and finance real estate taxes and other carrying costs for the project for a significant period of time after completion of the project, until a buyer is identified. The maximum loan-to-value ratio applicable to these loans is generally 80% of the appraised market value upon completion of the project. In addition, a minimum of 25% verified equity is generally also required. Verified equity generally refers to cash equity invested in the project. Development plans are required from builders prior to committing to the loan. We require that builders maintain adequate title insurance and other appropriate insurance coverage, and, if applicable, a hazardous waste survey reporting that the land is free of hazardous or toxic waste. While maturity dates for residential construction loans are largely a function of the estimated construction period of the project and generally do not exceed one year, land development loans generally are for 18 to 24 months. Substantially all of our residential construction loans have adjustable-rates of interest based on The Wall Street Journal prime rate. During the term of construction, the accumulated interest on the loan is either added to the principal of the loan through an interest reserve or billed monthly. We have interest reserves on $8.1 million of our total speculative construction loans, with LIP totaling $6.7 million. When these loans exhaust their original reserves set up at origination, no additional reserves are permitted unless the loan is re-analyzed and it is determined that the additional reserves are appropriate, based on the updated analysis. Construction loan proceeds are disbursed periodically as construction progresses and as inspections by our approved inspectors warrant. Total outstanding net loan amounts for land development loans range from $166,000 to $4.6 million with an average individual loan commitment at December 31, 2012, of $2.1 million. At December 31, 2012, our three largest construction/land development loans had outstanding principal balances, net of LIP, of $4.6 million, $4.0 million and $1.2 million. The $4.0 million construction/land development loan was impaired at December 31, 2012 and the two other loans were performing in accordance with their terms.

Our construction/land development loans are based upon estimates of costs in relation to values associated with the completed project. Construction/land development lending involves additional risks when compared with permanent residential lending because funds are advanced 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 completed 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 related loan-to-value ratio. For these reasons, this type of lending also typically involves higher loan principal amounts and is often concentrated with a small number of builders. 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.

Business Lending. Business loans totaled $3.0 million, or less than 1.0% of the loan portfolio at December 31, 2012. Business loans are generally secured by business equipment, accounts receivable, inventory or other property. Loan terms typically vary from one to five years. The interest rates on such loans are either fixed- or adjustable-rate primarily indexed to The Wall Street Journal prime rate plus a margin. Our business lending policy includes credit file documentation and requires 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 our credit analysis. We generally obtain personal guarantees on our business loans. The largest business loan had an outstanding balance of $1.5 million at December 31, 2012 and was performing according to its repayment terms. At December 31, 2012, we did not have any business loans delinquent in excess of 90 days and/or in nonaccrual status.

Repayments of 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. Our business loans are originated primarily based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. Credit support provided by the borrower for most of these loans and the probability of repayment is based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any. As a result, 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. The collateral securing business loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Consumer Lending. We offer a limited variety of consumer loans to our customers, consisting primarily of home equity loans and savings account loans. Generally, consumer loans have shorter terms to maturity and higher interest rates than one-to-four family residential loans. Consumer loans are offered with both fixed and adjustable interest rates and with varying terms. At December 31, 2012, consumer loans were $11.1 million, or 1.7% of the total loan portfolio.

At December 31, 2012, the largest component of the consumer loan portfolio consisted of home equity loans, primarily home equity lines of credit, which totaled $8.5 million, or 76.8% of the total consumer loan portfolio. The home equity lines of credit include $4.4 million of equity lines of credit in first lien position and $4.1 million of second mortgages on residential properties. At December 31, 2012, unfunded commitments on our home equity lines of credit totaled $4.2 million. Home equity loans are made for purposes such as the improvement of residential properties, debt consolidation and education expenses. At origination, the loan-to-value ratio is generally 90% or less, when taking into account both the balance of the home equity loans and the first mortgage loan. Second mortgage loans are originated on a fixed- or adjustable-rate basis. The interest rate for the adjustable-rate second mortgages is tied to the prime rate published in The Wall Street Journal and may include a margin. Second mortgages generally have a ten year term with a balloon payment due at maturity.

Consumer loans entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by rapidly depreciating assets. In these cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower’s continuing financial stability, and are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans. Home equity lines of credit have greater credit risk than one-to-four family residential mortgage loans because they are generally secured by mortgages subordinated to the existing first mortgage on the property, which we may or may not hold in our portfolio. We do not have private mortgage insurance coverage on these loans. Adjustable-rate loans may experience a higher rate of default in a rising interest rate environment due to the increase in payment amounts caused by the increase in interest rates as loan rates reset. If current economic conditions deteriorate for our borrowers and their home prices continue to fall, we may also experience higher credit losses from this loan portfolio. Since our home equity loans primarily consist of second mortgage loans, it is unlikely that we will be successful in recovering all, if any, portion of our loan principal amount outstanding in the event of a default. At December 31, 2012, consumer loans totaling $759,000 were delinquent in excess of 90 days or in nonaccrual status. Consumer loans totaling $491,000 were charged-off during the year ended December 31, 2012. Consumer loans charged-off during the years ended December 31, 2011 and 2010 totaled $263,000 and $790,000, respectively.

Loan Maturity and Repricing. The following table sets forth certain information at December 31, 2012 regarding the amount of loans repricing or maturing in our portfolio based on their contractual terms to maturity, but does not include prepayments. Loan balances do not include undisbursed loan funds, deferred loan fees and costs and the ALLL.

	Within One Year	After One Year Through Three Years	After Three Years Through Five Years	After Five Years Through Ten Years	Beyond Ten Years	Total
	(In thousands)					
Real Estate:						
One-to-four family residential	$15,473	$54,986	$52,528	$45,635	$138,406	$307,028
Multifamily	23,411	10,287	22,699	51,311	3,813	111,521
Commercial	38,771	36,134	51,520	95,188	265	221,878
Construction/land development	15,456	3,962	—	—	—	19,418
Total real estate	93,111	105,369	126,747	192,134	142,484	659,845
Business	2,278	407	283	—	—	2,968
Consumer	10,062	69	408	532	39	11,110
Total	$105,451	$105,845	$127,438	$192,666	$142,523	$673,923

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The following table sets forth the amount of all loans due after December 31, 2013, with fixed or adjustable interest rates.

	Fixed-Rate	Adjustable-Rate	Total
	(In thousands)		
Real Estate:			
One-to-four family residential	$253,727	$37,828	$291,555
Multifamily	76,601	11,509	88,110
Commercial	170,779	12,328	183,107
Construction/land development	3,962	—	3,962
Total real estate	505,069	61,665	566,734
Business	690	—	690
Consumer	1,048	—	1,048
Total	$506,807	$61,665	$568,472

Loan Solicitation and Processing. The majority of our consumer and residential mortgage loan originations are generated through the Bank and from time to time through outside brokers. We originate multifamily, commercial real estate and construction/land development loans primarily using the Bank’s loan officers, with referrals coming from builders, brokers and existing customers.

Upon receipt of a loan application from a prospective borrower, we obtain a credit report and other data to verify specific information relating to the loan applicant’s employment, income, and credit standing. All real estate loans requiring an appraisal are done by an independent third-party appraiser. All appraisers are approved by us, and their credentials are reviewed annually, as is the quality of their appraisals.

We use a multi-level approval matrix which establishes lending targets and tolerance levels depending on the type of credit being approved. The matrix also sets minimum credit standards for each of the various types of credits as well as approval limits.

Lending Authority. The Bank's lending authority limits are as follows:

Board of Directors. The Bank’s Board of Directors has the following authority to approve each loan request:

- With an aggregate relationship in excess of 15% of the Bank’s risk-based capital;
- Each one-to-four family residential loan request in excess of $5.0 million; and
- Each commercial or multifamily loan request in excess of $10.0 million.

Directors’ Loan Committee. The Directors’ Loan Committee consists of at least three members of the Board of Directors. The Directors’ Loan Committee has the authority to approve:

- The aggregate borrower relationships up to 15% of the Bank’s risk-based capital; and
- Each loan request in excess of the Loan Committee thresholds up to $5.0 million for consumer loans and $10.0 million for commercial and multifamily loans.

Loan Committee. The Loan Committee consists of the Chief Credit Officer, Chief Lending Officer, Credit Administration Portfolio Manager, Loan Administration Manager, Consumer Lending Manager and the Commercial Banking Manager along with two additional members who are appointed by the Chief Credit Officer. The Loan Committee has the following authority to approve:

-

Each loan request above the Combined Loan Signing Authority levels up to $1.5 million for one-to-four family residential loans and $5.0 million for commercial and multifamily loans;

- The aggregate borrower relationships above the Combined Loan Signing Authority levels up to $15.0 million; and
- Each unsecured consumer loan request above the Combined Loan Signing Authority levels up to $25,000.

Combined Loan Signing Authority. Combined loan signing authority requires two lending officers' approval, both must hold positions higher than the recommending officer, one of which must be the Chief Lending Officer or the Chief Credit Officer. The Combined Loan Signing Authority allows for the following authority to approve:

- Each loan request for general conforming one-to-four family residential, owner occupied loans up to Freddie Mac and Fannie Mae conforming loan limits;
- Each loan request for commercial and multifamily loans up to $1.0 million;
- The aggregate borrower relationships up to $1.0 million;
- Each unsecured consumer loan request up to $10,000; and
- Each loan that is 100% secured by cash in the Bank.

During 2012, we did not delegate individual signing authority to any one lending or executive officer.

Loan Originations, Servicing, Purchases, Sales and Repayments. For the years ended December 31, 2012 and 2011, our total loan originations were $118.8 million and $31.6 million, respectively. Total loan originations increased as a result of loan demand in our market area and our renewed focus on generating loan volume during the six months ended December 31, 2012.

One-to-four family residential loans are generally originated in accordance with the guidelines established by Freddie Mac and Fannie Mae, with the exception of our special community development loans originated to satisfy compliance with the Community Reinvestment Act. Our loans are underwritten by designated real estate loan underwriters internally in accordance with standards as provided by our Board-approved loan policy. We require title insurance on all loans and fire and casualty insurance on all secured loans and home equity loans where real estate serves as collateral. Flood insurance is also required on all secured loans when the real estate is located in a flood zone.

We may sell loans from time to time on a non-recourse basis consistent with our asset and liability management objectives. Fixed-rate residential mortgage loans with terms of 30 years or less and adjustable-rate mortgage loans are generally held in our portfolio. Loans sales for 2012 were $1.1 million compared to none for 2011.

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

	Year Ended December 31,		
	2012	2011	2010
	(In thousands)		
Loan Originations:			
Real estate:			
One-to-four family residential	$24,633	$11,201	$14,578
Multifamily	27,331	6,813	16,087
Commercial	48,706	4,079	12,596
Construction/land development	12,697	1,434	9,048
Total real estate	113,367	23,527	52,309
Business	756	2,270	293
Consumer	4,660	5,829	6,786
Total loans originated	118,783	31,626	59,388
Loans purchased	136	1,647	3,503
Loans sold	(1,051)	—	—
Principal repayments	(145,210)	(165,460)	(170,011)
Charge-offs	(9,591)	(11,025)	(65,476)
Loans transferred to OREO	(12,124)	(26,194)	(50,237)
Change in other items, net	(3,763)	16,238	39,989

Net decrease in loans	$(52,820)	$(153,168)	$(182,844)

Loan Origination and Other Fees. In some instances, we receive loan origination fees on real estate-related products. Loan fees generally represent a percentage of the principal amount of the loan and are paid by the borrower. The amount of fees charged to the borrower on one-to-four family residential loans and multifamily and commercial real estate loans can range between

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0% to 2%. United States generally accepted accounting principles require that certain fees received, net of certain origination costs, be deferred and amortized over the contractual life of the loan. Net deferred fees or costs associated with loans that are prepaid or sold are recognized in income at the time of prepayment or sale. We had $2.1 million and $1.8 million of net deferred loan fees as of December 31, 2012 and 2011, respectively.

One-to-four family residential and consumer loans are generally originated without a prepayment penalty. The majority of our multifamily and commercial real estate loans, however, have prepayment penalties associated with the loans. The majority of the recent multifamily and commercial real estate loan originations have a prepayment penalty of 3% of the principal balance in year one, 2% in year two, 1% in year three and no penalties after year three.

Asset Quality

As of December 31, 2012, we had an aggregate of $15.8 million, or 2.4% of total loans, net of LIP, past due over 60 days. These loans consisted of 19 one-to-four family residential loans (16 owner-occupied and three non-owner occupied), six commercial real estate loans, one construction/land development loan, four multifamily loans and three consumer loans. We generally assess late fees or penalty charges on delinquent loans of up to 5.0% of the monthly payment. The borrower is given up to a 15 day grace period from the due date to make the loan payment.

We handle collection procedures internally or with the assistance of outside legal counsel. Late charges are incurred when the loan exceeds 10 to 15 days past due depending upon the loan product. When a delinquent loan is identified, corrective action takes place immediately. The first course of action is to determine the cause of the delinquency and seek cooperation from the borrower in resolving the issue whenever possible. Additional corrective action, if required, will vary depending on the borrower, the collateral, if any, and whether the loan requires specific handling procedures as required by the Washington State Deed of Trust Act.

If the borrower is chronically delinquent and all reasonable means of obtaining payments have been exhausted, we will seek to recover the collateral securing the loan according to the terms of the security instrument and applicable law. The following table shows our delinquent loans by the type of loan, net of LIP and the number of days delinquent at December 31, 2012:

	Loans Delinquent 31-60 Days		61-90 Days		Over 90 Days		Total Delinquent Loans	
	Number of Loans	Principal Balance	Number of Loans	Principal Balance	Number of Loans	Principal Balance	Number of Loans	Principal Balance
	(Dollars in thousands)							
Real estate:								
One-to-four family residential:								
Owner occupied	7	$1,974	4	$1,374	12	$2,653	23	$6,001
Non-owner occupied	2	1,276	1	49	2	1,019	5	2,344
Multifamily	—	—	—	—	4	4,711	4	4,711
Commercial	3	1,795	—	—	6	4,479	9	6,274
Construction/land development	—	—	—	—	1	805	1	805
Total real estate	12	5,045	5	1,423	25	13,667	42	20,135
Consumer	1	20	1	47	2	690	4	757
Total	13	$5,065	6	$1,470	27	$14,357	46	$20,892

Nonperforming Assets. The following table sets forth information with respect to our nonperforming assets and troubled debt restructured loans ("TDRs") for the periods indicated. All loan balances and ratios are calculated using loan balances that are net of LIP.

	December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Loans accounted for on a nonaccrual basis:					
Real estate:					
One-to-four family residential	$6,248	$9,808	$22,688	$36,874	$9,630
Multifamily	4,711	949	—	—	—
Commercial	6,274	3,736	7,306	11,535	2,865
Construction/land development	4,767	9,199	32,885	71,780	44,043
Consumer	759	—	57	514	—
Total loans accounted for on a nonaccrual basis	22,759	23,692	62,936	120,703	56,538
Loans accruing interest which are contractually past due 90 days or more:					
One-to-four family residential	—	—	—	—	1,207
Commercial real estate	—	—	—	—	897
Total loans accruing interest which are contractually past due 90 days or more	—	—	—	—	2,104
Total nonperforming loans	22,759	23,692	62,936	120,703	58,642
OREO	17,347	26,044	30,102	11,835	—
Total nonperforming assets	$40,106	$49,736	$93,038	$132,538	$58,642
TDRs:					
Nonaccrual [(1)]	$4,528	$5,079	$16,299	$26,021	$20,818
Performing	65,848	66,225	58,375	35,458	2,226
Total TDRs	$70,376	$71,304	$74,674	$61,479	$23,044
Nonperforming loans as a percent of total loans	3.42 %	3.28 %	7.14 %	11.23 %	5.56 %
Nonperforming loans as a percent of total assets	2.41	2.24	5.27	9.18	4.71
Nonperforming assets as a percent of total assets	4.25	4.69	7.79	10.08	4.71
Total loans	$665,067	$721,608	$881,411	$1,075,277	$1,055,011
Foregone interest on nonaccrual loans	1,399	2,178	6,069	7,299	2,090

(1) These loans are also included in the appropriate loan category above under the caption: “Loans accounted for on a nonaccrual basis.”

When a loan becomes 90 days past due, we generally place the loan on nonaccrual status unless the credit is well secured and is in the process of collection. Loans may be placed on nonaccrual status prior to being 90 days past due if there is an identified problem such as an impending foreclosure or bankruptcy or if the borrower is unable to meet their scheduled payment obligations. As of December 31, 2012, nonperforming loans, net of LIP, were $22.8 million, or 3.42% of total loans and 4.25% of total assets.

Our three largest nonperforming loans at December 31, 2012 were as follows:

- A construction/land development loan with an outstanding balance of $4.0 million. The purpose of the loan was to purchase land in Whatcom County and prepare the land for construction of a 251-unit, one-to-four family residential development.
- A multifamily loan with an outstanding balance of $2.7 million, secured by a 31-unit attached three building residential complex in Pierce County.

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- A commercial real estate loan with an outstanding balance of $2.6 million, secured by 11 condominium retail/office units located in Pierce County.

We have reduced our nonperforming loans by $933,000, or 3.9% at December 31, 2012 as compared to December 31, 2011. This reduction was accomplished by transferring nonperforming loans to OREO through the foreclosure process, taking deeds-in-lieu of foreclosure, accepting short sales and loan charge-offs. Because of our structure, we are able to make decisions regarding offers on OREO and the real estate underlying our nonperforming loans very quickly as compared to the larger institutions where decisions could take upwards of six to twelve months. This distinction has worked to our benefit in reducing our nonperforming loans and disposing of OREO.

The following tables summarize our total nonperforming loans, net of LIP and OREO, at December 31, 2012 by county and by type of loan or property:

	County								
	King	Pierce	Whatcom	Kitsap	All Other	Total Nonperforming Loans	Number of Loans	Percent of Total Nonperforming Loans	
	(Dollars in thousands)								
Nonperforming loans:									
One-to-four family residential	$3,579	$2,111	$—	$—	$558	$ 6,248	22	27.5	%
Multifamily	—	4,711	—	—	—	4,711	4	20.7	
Commercial real estate	129	4,781	—	—	1,364	6,274	9	27.6	
Construction/land development	—	—	3,962	—	805	4,767	2	20.9	
Consumer	689	22	—	—	48	759	4	3.3	
Total nonperforming loans	$4,397	$11,625	$3,962	$—	$2,775	$ 22,759	41	100.0	%

	County								
	King	Pierce	Whatcom	Kitsap	All Other	Total OREO	Number of Properties	Percent of Total OREO	
	(Dollars in thousands)								
OREO:									
One-to-four family residential	$2,349	$1,183	$—	$410	$375	$4,317	21	24.9	%
Commercial real estate [(1)]	1,569	6,993	—	1,136	724	10,422	21	60.1	
Construction/land development	—	1,345	—	654	609	2,608	7	15.0	
Total OREO	$3,918	$9,521	$—	$2,200	$1,708	$17,347	49	100.0	%
Total nonperforming assets	$8,315	$21,146	$3,962	$2,200	$4,483	$40,106			

(1) Of the 21 properties classified as commercial real estate, nine are office/retail buildings, three are mixed-use buildings, five are developed lots and four are undeveloped lots.

Construction/land development, commercial real estate and multifamily loans have larger individual loan amounts, which have a greater single impact on our total portfolio quality in the event of delinquency or default. We continue to monitor our loan portfolio and believe additions to nonperforming loans, charge-offs, provisions for loan losses, and/or OREO are possible in the future, particularly if the housing market and other economic conditions do not continue to improve.

Other Real Estate Owned. Real estate acquired by us as a result of foreclosure or by deed-in-lieu of foreclosure is classified as OREO until it is sold. When the property is acquired, it is recorded at the lower of its cost or the fair market value of the property, less selling costs. We had $17.3 million and $26.0 million of OREO at December 31, 2012 and 2011, respectively. At December 31, 2012, OREO consisted of $4.3 million in one-to-four family residential properties, $2.6 million in construction/land development properties and $10.4 million in commercial real estate properties. We have a special assets department whose primary focus is the prompt and effective management of our troubled, nonperforming assets and to expedite their disposition and minimize any potential losses. During 2012, we foreclosed or accepted deeds-in-lieu of foreclosure on 35 properties totaling $12.1 million as compared to 95 properties totaling $26.2 million during 2011. We anticipate continued foreclosure, deed-in-lieu of foreclosure and short sale activity while we work with our nonperforming loan customers to minimize our loss exposure.

Troubled Debt Restructured Loans. We account for certain loan modifications or restructurings as TDRs. In general, the modification or restructuring of a debt is considered a TDR if we, for economic or legal reasons related to the borrower's financial difficulties, grant a concession to the borrower that we would not otherwise consider. At December 31, 2012, we had $70.4 million in TDRs as compared to $71.3 million at December 31, 2011.

Prior to 2012, we utilized a strategy for a limited number of our lending relationships by establishing an “A” and “B” note structure. We created an “A” note which represents a reduced principal balance expected to be fully collected and at a debt service level and loan-to-value ratio acceptable to us. The “A” note is classified as a performing TDR as long as the borrower continues to perform in accordance with the note terms. The “B” note represents the amount of the principal reduction portion of the original note and is immediately charged-off. The “B” note is held by the Bank and when the borrower pays off the “A” note, the Bank will proceed with collection efforts on the “B” note. At December 31, 2012, 93.6% of our TDRs were classified as performing compared to 92.9% at December 31, 2011. Of the $65.8 million of performing TDRs at December 31, 2012, $32.6 million were related to an “A” note as a result of an “A” and “B” note workout strategy. During 2012 we did not receive any principal or interest payments related to the "B" notes.

The largest TDR relationship at December 31, 2012 totaled $13.1 million and was comprised of 84 one-to-four family residential rental properties located in King, Kitsap, Pierce and Thurston counties. At December 31, 2012, there were no LIP in connection with these restructured and impaired loans. For additional information regarding our TDRs, see Note 5 of the Notes to Consolidated Financial Statements contained in Item 8.

The following table summarizes our total TDRs:

	December 31,	
	2012	2011
	(In thousands)	
Nonperforming TDRs:		
One-to-four family residential	$3,422	$3,994
Multifamily	1,058	—
Commercial real estate	—	902
Construction/land development	—	183
Consumer	48	—
Total nonperforming TDRs	4,528	5,079
Performing TDRs:		
One-to-four family residential	52,644	52,768
Multifamily	1,239	2,504
Commercial real estate	11,965	10,883
Consumer	—	70
Total performing TDRs	65,848	66,225
Total TDRs	$70,376	$71,304

Classified Assets. Federal regulations provide for the classification of lower quality loans and other assets as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses 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 we classify problem assets as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem assets. When an insured institution classifies problem assets as a loss, it is required to charge-off those assets in the period in which they are deemed uncollectible. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the FDIC and the DFI, which can order the establishment of additional loss allowances or the charge-off of specific loans against established loss reserves. Assets which do not currently expose us to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are designated by us as special mention.

In connection with the filing of periodic reports with the FDIC and in accordance with our loan policy, we regularly review the problem loans in our portfolio to determine whether any loans require classification in accordance with applicable regulations. On the basis of our review of our loans, as of December 31, 2012, $22.3 million of our loans were classified as special mention, $29.3 million were classified as substandard, and no loans were classified as doubtful or loss. This compares to $33.8 million classified as special mention, $38.3 million classified as substandard, and no loans classified as doubtful or loss as of December 31, 2011. The decrease in our classified loans during the year ended December 31, 2012 was a result of loan charge-offs, transfers to OREO and short sales, as well as our efforts to work with our borrowers to bring their loans current when possible or restructure the loan when appropriate. During 2012, we took an aggressive approach to reduce nonperforming assets and improve asset quality.

The aggregate amounts of our classified loans, net of LIP at the dates indicated were as follows:

	December 31,	
	2012	2011
	(In thousands)	
Classified Loans:		
Special mention:		
One-to-four family residential	$10,433	$13,193
Multifamily	—	5,414
Commercial real estate	11,666	14,256
Construction/land development	165	424
Consumer	—	488
Total special mention	22,264	33,775
Substandard:		
One-to-four family residential	9,826	14,376
Multifamily	5,950	949
Commercial real estate	7,805	13,584
Construction/land development	4,767	9,199
Consumer	981	189
Total substandard	29,329	38,297
Total classified loans	$51,593	$72,072

With the exception of these classified loans, of which $22.8 million were accounted for as nonaccrual loans at December 31, 2012, management is not aware of any loans as of December 31, 2012, where the known credit problems of the borrower would cause us to have serious doubts as to the ability of such borrowers to comply with their present loan repayment terms and which may result in the future inclusion of such loans in the nonperforming loan categories.

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

Our Audit Committee approves the provision for loan losses on a quarterly basis and the Board of Directors ratifies the Audit Committee's actions. 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 $3.1 million, $4.7 million and $53.1 million for the years ended December 31, 2012, 2011 and 2010, respectively. The decrease in the provision for loan losses was attributable to the reductions in the levels of nonperforming and classified assets, charge-offs and our directed focus during 2012 to work with our borrowers when possible to bring their loan payments current and when this option was not feasible, to initiate foreclosure or deed-in-lieu of foreclosure proceedings. We also utilized short sales as an option to liquidate properties prior to foreclosure. Loan charge-offs resulting from short sales totaled $60,000 during the year ended December 31, 2012. The focus that we placed on reducing our nonperforming assets during 2012 resulted in a reduction of $9.6 million in nonperforming assets. The ALLL was $12.5 million, or 1.9% of total loans at December 31, 2012 as compared to $16.6 million, or 2.3% of total loans outstanding at December 31, 2011. The level of the ALLL is based on estimates and the ultimate losses may vary from the estimates. Management reviews the adequacy of the ALLL on a quarterly basis.

A loan is considered impaired when, based on current information and events, it is probable we will be unable to collect the scheduled payments of principal or interest when due, according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, market conditions, rent rolls and the borrower's and guarantor's, if any, financial strength. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including length of the delay, the reasons for the delay, the borrower’s prior payment record and the amounts of the shortfall in relation to the principal and interest owed. Loans are evaluated for impairment on a loan-by-loan basis. As of December 31, 2012 and 2011, impaired loans, net of LIP, were $88.6 million and $89.9 million, respectively.

The following table summarizes the distribution of the ALLL by loan category, at the dates indicated.

	December 31,										
	2012			2011			2010			2009	
	Loan Balance	Allowance by Loan Category	Percent of Loans to Total Loans	Loan Balance	Allowance by Loan Category	Percent of Loans to Total Loans	Loan Balance	Allowance by Loan Category	Percent of Loans to Total Loans	Loan Balance	Allowan by Loan Categor
Real estate:	(Dollars in thousands)										
One-to-four family residential	$307,028	$5,562	45.6 %	$335,412	$5,756	46.4 %	$398,690	$8,302	44.7 %	$496,731	$11,13
Multifamily	111,521	1,139	16.5	113,674	950	15.7	144,876	1,893	16.2	146,508	1,896
Commercial	221,878	5,207	32.9	232,343	6,846	32.1	272,713	6,742	30.6	288,996	6,422
Construction/land development	19,418	437	2.9	25,143	2,503	3.5	56,501	5,151	6.3	163,953	13,255
Total real estate	659,845	12,345	97.9	706,572	16,055	97.7	872,780	22,088	97.8	1,096,188	32,703
Business	2,968	30	0.4	3,909	154	0.6	479	7	0.1	353	6
Consumer	11,110	167	1.7	12,499	350	1.7	19,127	439	2.1	18,678	330
Total	$673,923	$12,542	100.0%	$722,980	$16,559	100.0%	$892,386	$22,534	100.0%	$1,115,219	$33,03

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We believe that the ALLL as of December 31, 2012 was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the ALLL are reasonable, there can be no assurance that such estimates and assumptions will be proven correct 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 our financial condition and results of operations. Future additions to the ALLL may become necessary based upon changing economic conditions, the level of problem loans, business conditions, credit concentrations, increased loan balances or changes in the underlying collateral of the loan portfolio. In addition, the determination of the amount of the ALLL is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional loss reserves or the charge-off of specific loans against established loss reserves based upon their judgment of information available to them at the time of their examination.

The following table sets forth an analysis of our ALLL at the dates and for the periods indicated.

	At or For the Year Ended December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
ALLL at beginning of period	$16,559	$22,534	$33,039	$16,982	$7,971
Provision for loan losses	3,050	4,700	53,100	51,300	9,443
Charge-offs:					
One-to-four family residential	(2,229)	(2,330)	(24,594)	(6,043)	—
Multifamily	(153)	(125)	—	—	—
Commercial real estate	(6,088)	(4,249)	(8,012)	(2,812)	—
Construction/land development	(630)	(4,058)	(32,080)	(26,283)	(432)
Consumer	(491)	(263)	(790)	(164)	—
Total charge-offs	(9,591)	(11,025)	(65,476)	(35,302)	(432)
Total recoveries	2,524	350	1,871	59	—
Net charge-offs	(7,067)	(10,675)	(63,605)	(35,243)	(432)
ALLL at end of period	$12,542	$16,559	$22,534	$33,039	$16,982
ALLL as a percent of total loans, net of LIP	1.89%	2.29%	2.56%	3.07%	1.61%
Net charge-offs to average loans receivable, net	1.07	1.39	6.55	3.38	0.04
ALLL as a percent of nonperforming loans, net of LIP	55.11	69.89	35.80	27.37	28.96

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, commercial paper, investment grade corporate debt securities, and obligations of states and their political sub-divisions.

The Investment Committee, consisting of the Chief Executive Officer, Chief Financial Officer and Controller of First Savings Bank, has the authority and responsibility to administer our investment policy, monitor portfolio strategies and recommend appropriate changes to policy and strategies to the Board of Directors. On a monthly basis, management reports to the Board a summary of investment holdings with respective market values and all purchases and sales of investment securities. The Chief Financial Officer has the primary responsibility for the management of the investment portfolio and considers various factors when making decisions, including the marketability, maturity and tax consequences of proposed investments. 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 investment portfolio are 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.

At December 31, 2012, our investment portfolio consisted principally of mortgage-backed securities, U.S. Government Agency obligations and municipal bonds. From time to time, investment levels may increase or decrease depending upon yields available on investment opportunities and management's projected demand for funds for loan originations, deposits and other activities.

Mortgage-Backed Securities. The mortgage-backed securities in our portfolio were comprised of Fannie Mae, Freddie Mac and Ginnie Mae mortgage-backed securities. These issuers guarantee the timely payment of principal and interest in the event of default. The mortgage-backed securities had a weighted-average yield of 2.27% at December 31, 2012.

U.S. Government Agency Obligations. The agency securities in our portfolio were comprised of Fannie Mae, Freddie Mac and FHLB agency securities. These issuers guarantee the timely payment of principal and interest in the event of default. At December 31, 2012, the portfolio had a weighted-average yield of 0.52%.

Ginnie Mae is part of a U.S. Government agency and its guarantees are backed by the full faith and credit of the United States. Fannie Mae, Freddie Mac and the Federal Home Loan Banks are U.S. Government-sponsored entities. Although their guarantees are not backed by the full faith and credit of the United States, they may borrow from the U.S. Treasury and the U.S. Treasury has taken other steps designed to ensure these U.S. Government-sponsored entities can fulfill their financial obligations.

Municipal Bonds. The municipal bond portfolio was comprised of general obligation bonds (i.e., backed by the general credit of the issuer) and revenue bonds (i.e., backed by revenues from the specific project being financed) issued by various municipalities. All bonds are from issuers located within the state of Washington. The weighted-average yield on the municipal bond portfolio was 6.87% at December 31, 2012.

Federal Home Loan Bank Stock. As a member of the FHLB, we are required to own capital stock in the FHLB. The amount of stock we hold is based on guidelines specified by the FHLB. The redemption of any excess stock we hold is at the discretion of the FHLB. The carrying value of the stock totaled $7.3 million at December 31, 2012. We did not receive dividends during the years ended December 31, 2012, 2011 and 2010. At December 31, 2012, we held no securities of any single issuer (other than government-sponsored entities) that exceeded 10% of our shareholders' equity.

Management evaluates FHLB stock for impairment. The determination of whether this investment is impaired is based on our assessment of the ultimate recoverability of cost, rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB and (4) the liquidity position of the FHLB.

On October 25, 2011, the FHLB agreed to the stipulation and issuance of a Consent Order by its primary regulator, the Federal Housing Finance Agency ("FHFA"). The Consent Order sets forth requirements for capital management, asset composition and other operational and risk management improvements as well as requiring the FHFA's approval for the FHLB to repurchase member stock or pay dividends. In September 2012, the FHLB was notified by the FHFA that it is now classified as "adequately capitalized" as compared to the prior classification of "undercapitalized." Any dividends or repurchases of FHLB stock, however, continue to require the consent of the FHFA. During the third quarter of

2012, the FHLB announced that the FHFA had granted it the authority to repurchase up to $25 million in excess capital stock per quarter, provided that its financial condition - measured primarily by the ratio of market value of equity-to-par value of capital stock - does not deteriorate. As a result, the FHLB repurchased shares on a pro-rata basis from its shareholders, including 1,320 shares from the Bank, at par value during 2012. The FHLB has not indicated when dividend payments may resume. We have determined there is not an other-than-temporary impairment ("OTTI") on our FHLB stock investment as of December 31, 2012. For additional information, see Item 1.A. “Risk Factors - Further deterioration in the financial position of the Federal Home Loan Bank of Seattle may result in future impairment losses on our investment in Federal Home Loan Bank of Seattle stock.”

The following table sets forth the composition of our investment portfolio at the dates indicated.

	December 31,					
	2012		2011		2010	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)					
Available-for-sale:						
Mortgage-backed securities:						
Fannie Mae	$35,039	$36,168	$50,981	$52,163	$109,134	$110,144
Freddie Mac	15,368	15,763	19,285	19,845	40,454	41,149
Ginnie Mae	31,193	31,146	7,416	7,495	9,542	9,444
Municipal bonds	2,048	1,889	2,085	1,847	2,395	1,922
U.S. Government agencies	67,077	67,296	47,934	47,652	1,805	1,944
Total available-for-sale	$150,725	$152,262	$127,701	$129,002	$163,330	$164,603

At December 31, 2012, 2011 and 2010 there were no investments held to maturity.

During the year ended December 31, 2012, gross proceeds from sales of investments were $23.8 million, with gross gains of $307,000 and gross losses of $6,000.

Management reviews investment securities on an ongoing basis for the presence of OTTI or permanent impairment, taking into consideration current market conditions, fair value in relationship to cost, extent and nature of the change in fair value, issuer rating changes and trends, whether management intends to sell a security or if it is likely that we will be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity, and other factors. For debt securities, if management intends to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If management does not intend to sell the security and it is not likely that we will be required to sell the security, but management does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate, depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (loss). Impairment losses related to all other factors are presented as separate categories within other comprehensive income (loss). There were no losses related to OTTI at December 31, 2012 and 2011. For additional information regarding our investments, see Note 4 of the Notes to Consolidated Financial Statements contained in Item 8.

The table below sets forth information regarding the carrying value and weighted-average yield by contractual maturity of our investment portfolio at December 31, 2012. Mortgage-backed securities and the FHLB stock investments have no stated maturity date and are included in the totals column only.

	December 31, 2012									
	Within One Year		After One Year Through Five Years		After Five Through Ten Years		Thereafter		Totals	
	Carrying Value	Weighted-Average Yield	Carrying Value	Weighted-Average Yield	Carrying Value	Weighted-Average Yield	Carrying Value	Weighted-Average Yield	Carrying Value	Weighted-Average Yield
	(Dollars in thousands)									
Available-for-sale:										
Mortgage-backed securities	$—	— %	$—	— %	$—	— %	$—	— %	$83,077	2.27 %
Municipal bonds	—	—	—	—	502	6.03	1,387	7.14	1,889	6.87
U.S. Government agencies	—	—	50,089	0.31	4,195	0.98	13,012	1.29	67,296	0.52
Total available-for-sale	$—	—	$50,089	0.31	$4,697	1.56	$14,399	1.95	$152,262	1.54
FHLB stock	$—	—	$—	—	$—	—	$—	—	$7,281	—

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Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major sources of our 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 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.

Our deposit composition reflects a mixture of various deposit products. We rely on marketing activities, customer service and the availability of a broad range of deposit products and services to attract and retain customer deposits.

Deposits. We offer a range of deposit products within our market area, including noninterest bearing accounts, NOW accounts, money market deposit accounts, statement savings accounts and certificates of deposit. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of our deposit accounts, we consider the development of long-term profitable customer relationships, current market interest rates, current maturity structures, deposit mix, our customer preferences and the profitability of acquiring customer deposits compared to alternative sources.

At December 31, 2012, our deposits totaled $665.8 million. We had $331.6 million of jumbo ($100,000 or more) certificates of deposit, of which $1.7 million were public funds, which represent 49.8% and 0.3%, respectively, of total deposits. As part of our strategy, we did not renew maturing public fund certificates of deposit during 2012 due to the higher cost of maintaining those accounts as a result of the changes in state law. Under Washington State law, in order to participate in the public funds program, we are required to pledge 100% of the public deposits held in the form of eligible securities. There were no brokered deposits at December 31, 2012.

Deposit Activities. The following table sets forth our total deposit activity for the periods indicated.

	At or For the Year Ended December 31,		
	2012	2011	2010
	(In thousands)		
Beginning balance	$788,665	$920,226	$939,423
Net decrease before interest credited	(132,632)	(147,065)	(41,294)
Interest credited	9,764	15,504	22,097
Net decrease in deposits	(122,868)	(131,561)	(19,197)
Ending balance	$665,797	$788,665	$920,226

The following table sets forth information regarding our certificates of deposit and other deposits at December 31, 2012.

Weighted-Average Interest Rate		Term	Category	Amount	Minimum Balance	Percentage of Total Deposits	
(Dollars in thousands)							
—	%	N/A	Noninterest bearing demand deposits	$6,154	$—	0.9	%
0.14		N/A	NOW	15,944	250	2.4	
0.20		N/A	Statement savings	18,273	25	2.8	
0.24		N/A	Money market	161,719	1,000	24.3	
			Certificates of deposit:				
0.28		3 month		2,069	1,000	0.3	
0.34		6 month		3,618	1,000	0.5	
0.40		9 month		853	1,000	0.1	
0.45		Variable 12 month		22	1,000	—	
0.66		12 month		81,174	1,000	12.2	
0.77		13 month		6,394	1,000	1.0	
0.72		18 month		52,413	500	7.9	
1.00		24 month		31,685	1,000	4.8	
1.23		30 month		35,128	1,000	5.3	
1.68		36 month		59,418	1,000	8.9	
2.47		48 month		189,377	1,000	28.4	
3.25		60 month		1,446	1,000	0.2	
5.15		72 month		110	1,000	—	
			Total certificates of deposit	463,707		69.6	
			Total	$665,797		100.0	%

Certificates of Deposit. The following table sets forth the amount and maturities of certificates of deposit at December 31, 2012.

	Within One Year	After One Year Through Two Years	After Two Years Through Three Years	After Three Years Through Four Years	Thereafter	Total
	(In thousands)					
0.00 - 1.00%	$129,227	$50,170	$5,613	$—	$—	$185,010
1.01 - 2.00%	26,121	30,616	51,416	16,857	—	125,010
2.01 - 3.00%	45,947	71,944	129	—	—	118,020
3.01 - 4.00%	33,296	1,812	—	—	—	35,108
4.01 - 5.00%	449	—	—	—	—	449
5.01 - 6.00%	—	—	—	—	110	110
Total	$235,040	$154,542	$57,158	$16,857	$110	$463,707

The following table sets forth the amount of our jumbo certificates of deposit by remaining maturity as of December 31, 2012. Jumbo certificates of deposit are certificates in amounts of $100,000 or more.

Maturity Period	Certificates of Deposit (In thousands)
Three months or less	$54,318
Over three months through six months	35,748
Over six months through twelve months	77,513
Over twelve months	164,045
Total	$331,624

Deposit Flow. The following table sets forth the deposit balances by the types of accounts we offered at the dates indicated.

	December 31, 2012			2011			2010		
	Amount	Percent of Total		Amount	Percent of Total		Amount	Percent of Total	
	(Dollars in thousands)								
Noninterest-bearing	$6,154	0.9	%	$6,013	0.8	%	$8,700	1.0	%
NOW	15,944	2.4		14,193	1.8		13,458	1.4	
Statement savings	18,273	2.8		17,784	2.2		15,387	1.7	
Money market	161,719	24.3		180,631	22.9		193,982	21.1	
Certificates of deposit:									
0.00 - 1.00%	185,010	27.8		113,318	14.4		22,666	2.5	
1.01 - 2.00%	125,010	18.8		197,887	25.1		316,964	34.4	
2.01 - 3.00%	118,020	17.7		168,105	21.3		203,123	22.1	
3.01 - 4.00%	35,108	5.3		62,027	7.9		73,918	8.0	
4.01 - 5.00%	449	—		12,721	1.6		24,208	2.6	
5.01 - 6.00%	110	—		15,986	2.0		47,820	5.2	
Total certificates of deposit	463,707	69.6		570,044	72.3		688,699	74.8	
Total	$665,797	100.0	%	$788,665	100.0	%	$920,226	100.0	%

Borrowings. Customer deposits are the primary source of funds for our lending and investment activities. We use advances from the FHLB to supplement our 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. In addition, at December 31, 2012 we had available a $10.0 million line of credit with another financial institution as a supplemental funding source.

As a member of the FHLB, we are required to own capital stock in the FHLB and are authorized to apply for advances on the security of that stock and certain of our mortgage loans and other assets 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. We maintain a credit facility with the FHLB that provides for immediately available advances, subject to acceptable collateral. Effective February 27, 2012, our line of credit with the FHLB was increased to 25% of assets, subject to certain acceptable collateral requirements, from 10% at December 31, 2011. At December 31, 2012, our line of credit was $240.8 million and outstanding advances from the FHLB totaled $83.1 million.

The following table sets forth information regarding FHLB advances at the end of and during the periods indicated. The table includes both long- and short-term borrowings.

	At or for the Year Ended December 31,		
	2012	2011	2010
	(Dollars in thousands)		
Maximum amount of borrowings outstanding at any month end	$83,066	$93,066	$143,066
Average borrowings outstanding	83,067	90,656	130,423
Weighted-average rate paid	2.47 %	2.50 %	3.21 %
Balance outstanding at end of the year	$83,066	$83,066	$93,066
Weighted-average rate paid at end of the year	2.47 %	2.47 %	2.51 %

Subsidiaries and Other Activities

First Financial Northwest, Inc. First Financial Northwest has two wholly-owned subsidiaries, First Savings Bank and First Financial Diversified Corporation. First Financial Diversified Corporation primarily provides escrow services to First Savings Bank, other area lenders and some private individuals. First Financial Diversified Corporation also offers a limited number of loan products to First Savings Bank's customers. At December 31, 2012, loans from First Financial Diversified Corporation represented less than two percent of our loan portfolio.

First Savings Bank Northwest. First Savings Bank is a community-based savings bank primarily serving King and to a lesser extent, Pierce, Snohomish and Kitsap counties, Washington through our full-service banking office located in Renton, Washington. We are in the business of attracting deposits from the public and utilizing those deposits to originate loans.

Competition

We face competition in originating loans and attracting deposits within our targeted geographic market area. We compete by consistently delivering high-quality, personal service to our customers that results in a high level of customer satisfaction.

Based on the most current FDIC Deposit Market Share Report dated June 30, 2012, we ranked 12th in terms of deposits with a deposit market share of 1.30%, among the 55 FDIC-insured depository institutions located in King County. Our key competitors are U.S. Bank, Key Bank, Union Bank, Columbia Bank, Sterling Bank and Washington Federal. These competitors controlled 30.7% of the King County deposit market with deposits of $17.7 billion of the $57.5 billion total deposits in King County as of June 30, 2012. Aside from these traditional competitors, credit unions, insurance companies and brokerage firms also compete for consumer deposit relationships.

Our competition for loans comes principally from commercial banks, mortgage brokers, thrift institutions, credit unions and finance companies. Several other financial institutions, including those previously mentioned, compete with us for banking business in our targeted market area. These institutions have far more resources than we do and as a result are able to offer a broader range of services such as trust departments, merchant banking and enhanced retail services. Among the advantages of some of these institutions are their ability to make larger loans, finance extensive advertising campaigns, access lower cost funding sources and allocate their investable assets in regions of highest yield and demand. The challenges posed by such large competitors may impact our ability to originate loans, secure low cost deposits and establish product pricing levels that support our net interest margin goals, which may limit our future growth and earnings potential.

Employees

At December 31, 2012, we had 113 full-time employees. Our employees are not represented by any collective bargaining group. We consider our employee relations to be good.

How We Are Regulated

The following is a brief description of certain laws and regulations which are applicable to First Financial Northwest and First Savings Bank. Legislation is introduced from time to time in the U.S. Congress that may affect the operations of First Financial Northwest and First Savings Bank. In addition, the regulations governing us may be amended from time to time by the respective regulators. Any such legislation or regulatory changes in the future could adversely affect us. We cannot predict whether any such changes may occur.

First Savings Bank is regulated by the FDIC and the DFI. First Savings Bank elected, pursuant to Section 10(l) of the Home Owners' Loan Act, as amended, to be treated as a savings association. As a result, First Financial Northwest is a registered savings and loan holding company subject to regulation of the Federal Reserve.

New Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. The following discussion summarizes significant aspects of the Dodd-Frank Act that may affect First Savings Bank and First Financial Northwest. For certain of these changes, implementing regulations have not been promulgated, so we cannot determine the full impact of the Dodd-Frank Act on our business and operations at this time.

The following aspects of the Dodd-Frank Act are related to First Savings Bank:

- The Consumer Financial Protection Bureau ("CFPB"), an independent consumer compliance regulatory agency within the Federal Reserve, has been established. The CFPB is empowered to exercise broad regulatory, supervisory and enforcement authority over financial institutions with total assets of over $10 billion with respect to both new and existing consumer financial protection laws. Financial institutions with assets of less than $10 billion, like the Bank, will continue to be subject to supervision and enforcement by their primary federal banking regulator with respect to federal consumer financial protection laws. The CFPB also has authority to promulgate new consumer financial protection regulations and amend existing consumer financial protection regulations;
- The Federal Deposit Insurance Act was amended to direct federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries;
- The prohibition on payment of interest on demand deposits was repealed;
- Deposit insurance was permanently increased to $250,000;
- The deposit insurance assessment base for FDIC insurance was revised to reflect the depository institution's total average assets minus the sum of its average tangible equity during the assessment period; and
- The minimum reserve ratio of the FDIC's Deposit Insurance Fund ("DIF") increased to 1.35% of estimated annual insured deposits or assessment base; however, the FDIC is directed to "offset the effect" of the increased reserve ratio for insured depository institutions with total consolidated assets of less than $10 billion.

The following aspects of the Dodd-Frank Act are related to First Financial Northwest:

- The Federal Reserve has authority over savings and loan holding companies and has incorporated the regulations of the OTS that are applicable to savings and loan holding companies;
- Savings and loan holding companies will be subject to the same capital requirements as bank holding companies by 2015;
- Public companies are required to provide their shareholders with a non-binding vote: (i) at least once every three years on the compensation paid to executive officers and (ii) at least once every six years on whether they should have a "say on pay" vote every one, two or three years;
- A separate, non-binding shareholder vote is required 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;

- Securities exchanges are required to prohibit brokers from using their own discretion to vote shares not beneficially owned by them for certain “significant” matters, which include votes on the election of directors, executive compensation matters and any other matter determined to be significant;

- Stock exchanges are prohibited from listing the securities of any issuer that does not have a policy providing for (i) disclosure of its policy on incentive compensation payable on the basis of financial information reportable under the securities laws and (ii) the recovery from current or former executive officers, following an accounting restatement triggered by material noncompliance with securities law reporting requirements, of any incentive compensation paid erroneously during the three-year period preceding the date on which the restatement was required that exceeds the amount that would have been paid on the basis of the restated financial information;
- Disclosure in annual proxy materials is required concerning the relationship between the executive compensation paid and the financial performance of the issuer; and
- Item 402 of Regulation S-K is amended 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.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on First Financial Northwest and the financial services industry more generally. The elimination of the prohibition on the payment of interest on demand deposits could materially increase our interest expense, depending on our competitors’ responses. Provisions in the legislation that require revisions to the capital requirements for First Financial Northwest and First Savings Bank could require us to seek additional sources of capital in the future.

Regulation and Supervision of First Savings Bank Northwest

General. As a state-chartered savings bank, First Savings Bank is subject to applicable provisions of Washington law and regulations of the DIF. State law and regulations govern First Savings Bank’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. Under state law, savings banks in Washington state also generally have all of the powers that federal savings banks have under federal laws and regulations. First Savings Bank is subject to periodic examination and reporting requirements by and of the DFI.

Insurance of Accounts and Regulation by the FDIC. First Savings Bank’s deposits are insured up to $250,000 per deposit by the DIF of the FDIC. The Dodd-Frank Act permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious risk to the insurance fund. The FDIC also has the authority to initiate enforcement actions against savings institutions and may terminate the deposit insurance if it determines that the institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

First Savings Bank entered into the MOU with the FDIC and the DFI on March 27, 2012. The MOU, among other things, contains provisions concerning the management and directors of the Bank, interest rate risk, minimum capital levels, the ALLL, lending and collection policies, policies concerning the Bank and its affiliates, restrictions on paying dividends and a requirement to furnish progress reports to the FDIC and the DFI. In particular, the MOU provides that the Bank may not add a new director or executive officer without approval of the FDIC and the DFI. For additional information, see Item 1.A. “Risk Factors – Certain regulatory restrictions are imposed on us and lack of compliance could result in monetary penalties and/or additional regulatory actions.”

The Dodd-Frank Act requires the FDIC's deposit insurance assessments to be based on assets instead of deposits. The FDIC has issued rules, effective as of the second quarter of 2011, which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible equity capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC's reserve ratio equals 1.15%. Once the FDIC's reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above). No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

In addition, federally insured institutions are required to pay a Financing Corporation ("FICO") assessment in order to fund the interest on bonds issued to resolve thrift failures in the 1980s. For the year ended December 31, 2012, the FICO assessment equaled 0.66 basis points for each $100 in domestic deposits. These assessments, which may be revised based upon the level of

DIF deposits, will continue until the bonds mature in the years 2017 through 2019. For 2012, the Bank incurred approximately $55,000 in FICO assessments.

The Dodd-Frank Act contains a number of provisions that will affect the capital requirements applicable to First Financial Northwest and First Savings Bank. The Dodd-Frank Act requires new capital regulations to be adopted, however, the adoption of the capital regulations as proposed in December 2011 has been delayed. For additional information, see "- Capital Requirements" below.

The FDIC may terminate the deposit insurance of any insured depository institution, including First Savings Bank, if it determines after a hearing that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution meets certain criteria. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. We are not aware of any practice, condition or violation that might lead to termination of First Savings Bank's deposit insurance.

Prompt Corrective Action. Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon its capital levels in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is 10% or more, its ratio of core capital to risk-weighted assets is 6% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5% or more and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8%, a Tier 1 risk-based capital ratio of not less than 4% and a leverage ratio of not less than 4%. 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 that is neither well capitalized nor adequately capitalized is considered undercapitalized.

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. Undercapitalized institutions are also subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by institutions 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.

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 also 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 First Savings Bank fails to meet any standard prescribed by the guidelines, the agency may require First Savings Bank to submit to the agency an acceptable plan to achieve compliance with the standard. FDIC regulations establish deadlines for the submission and review of such safety and soundness compliance plans. We are not aware of any conditions relating to these safety and soundness standards which would require submission of a plan of compliance by First Savings Bank.

Capital Requirements. Federally insured savings institutions, such as First Savings Bank, are required to maintain a minimum level of regulatory capital. FDIC regulations recognize two types, or tiers, of capital: core ("Tier 1") capital and supplementary ("Tier 2") capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred stock (original maturity of at least five years but less than 20 years) that may be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution’s capital using a leverage limit together with certain risk-based ratios. The FDIC’s minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 4% of total assets. At December 31, 2012, First Savings Bank had a Tier 1 leverage capital ratio of 15.79%. The FDIC retains the right to require a particular institution to maintain a higher capital level based on its particular risk profile.

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

The DFI requires that net worth equal at least five percent of total assets. At December 31, 2012, First Savings Bank had Tier 1 risk-based capital of 26.11%.

The table below sets forth First Savings Bank’s capital position under the prompt corrective action regulations of the FDIC at December 31, 2012 and 2011 and the requirements pursuant to its MOU. The Bank’s Tier 1 capital ratio was 15.79% and our total risk-based capital ratio was 27.37% at December 31, 2012, both of which exceeded the requirements of the Bank's MOU of 10% and 12%, respectively.

	December 31,					
	2012			2011		
	Amount	Ratio		Amount	Ratio	
	(Dollars in thousands)					
Bank equity capital under GAAP	$150,761			$146,584		
Total risk-based capital	$157,254	27.37	%	$153,935	24.76	%
Total risk-based capital requirement	45,968	8.00		49,737	8.00	
Excess	$111,286	19.37	%	$104,198	16.76	%
Tier 1 risk-based capital	$150,006	26.11	%	$146,058	23.49	%
Tier 1 risk-based capital requirement	22,984	4.00		24,868	4.00	
Excess	$127,022	22.11	%	$121,190	19.49	%
Tier 1 leverage capital	$150,006	15.79	%	$146,058	13.54	%
Tier 1 leverage capital requirement	37,995	4.00		43,155	4.00	
Excess	$112,011	11.79	%	$102,903	9.54	%

As of December 31, 2012, the Bank was classified as a well-capitalized institution under the criteria established by the FDIC as a result of the Order being removed. At December 31, 2011, the Bank was well-capitalized, based on the general percentage guidelines, although the Bank was not regarded as well-capitalized for federal regulatory purposes as a result of being subject to the Order (see Note 2 of the Notes to Consolidated Financial Statements included in Item 8 of this Form 10-K).

First Savings Bank's management believes that, under the current regulations, First Savings Bank will continue to meet its minimum capital requirements in the foreseeable future. However, events beyond the control of First Savings Bank, such as a

downturn in the economy in areas where it has most of its loans, could adversely affect future earnings and, consequently, the ability of First Savings Bank to meet its capital requirements.
New Proposed Capital Rules. In connection with the enactment of the Dodd-Frank Act, in June 2012, the Federal Reserve, FDIC and the Office of the Comptroller of the Currency approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The proposed rules implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. "Basel III" refers to various documents released by the Basel Committee on Banking Supervision. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.
The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios, which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5% and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.
The proposed rules also implement other revisions to the current capital rules, such as recognition of all unrealized gains and losses on available-for-sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.
The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. Under the prompt corrective action requirements, insured depository institutions would be required to meet the following increased capital level requirements in order to qualify as "well capitalized:" (i) a new common equity Tier 1 risk-based capital ratio of 6.5%; (ii) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (iii) a Total risk-based capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (unchanged from the current rules).
The proposed rules set forth certain changes for the calculation of risk-weighted assets and utilize an increased number of credit risk and other exposure categories and risk weights. In addition, the proposed rules also address: (i) a proposed alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; and (iv) revised capital treatment for derivatives and repo-style transactions.
In particular, the proposed rules would expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures. Higher risk weights would apply to a variety of exposure categories. Specifics include, among others:

Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a risk weight of between 35% and 200% depending upon the mortgage's loan-to-value ratio and whether the mortgage is a "category 1" or "category 2" residential mortgage exposure (based on eight criteria that include, among others, the term, seniority of the lien, use of negative amortization, balloon payments and certain rate increases).

Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due. Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

Providing for a 100% risk weight for claims on securities firms.

Eliminating the current 50% cap on the risk weight for OTC derivatives.

Federal Home Loan Bank System. First Savings Bank is a member of the FHLB, which is one of 12 regional Federal Home Loan Banks that administer the home financing credit function of savings institutions. Each Federal Home Loan Bank serves as a reserve or central bank for its members within its assigned region. It is funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System. It 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 FHFA. All advances from the FHLB are required to be fully secured by sufficient collateral as determined by the FHLB. In addition, all long-term advances are required to provide funds for residential home financing. See "Business – Deposit Activities and Other Sources of Funds – Borrowings."

As a member, First Savings Bank is required to purchase and maintain stock in the FHLB. At December 31, 2012, the Bank had $7.3 million in FHLB stock, which was in compliance with this requirement. First Savings Bank did not receive any dividends from the FHLB for the year ended December 31, 2012. On October 25, 2011, the FHLB agreed to the stipulation and issuance of a Consent Order by its primary regulator, the FHFA. The Consent Order sets forth requirements for capital management, asset composition and other operational and risk management improvements as well as requiring the FHFA's approval for the FHLB to repurchase member stock or pay dividends. In September 2012, however, the FHLB announced that the FHFA had reclassified the FHLB to be adequately capitalized. Any dividends or repurchases of FHLB stock, however, continue to require consent of the FHFA. During the third quarter of 2012, the FHLB announced that the FHFA had granted them the authority to repurchase up to $25 million in excess capital stock per quarter, provided that their financial condition - measured primarily by the ratio of market value of equity-to-par value of capital stock - does not deteriorate. As a result, the FHLB repurchased shares on a pro-rata basis from its shareholders, including 1,320 shares from the Bank, at par value during the year ended December 31, 2012. The FHLB has not indicated when dividend payments may resume. For additional information, see Item 1.A. "Risk Factors - Further deterioration in the financial position of the Federal Home Loan Bank of Seattle may result in future impairment losses on our investment in Federal Home Loan Bank of Seattle stock."

The Federal Home Loan Banks 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 affected adversely 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 First Savings Bank's FHLB stock may result in a corresponding reduction in its capital.

Real Estate Lending Standards. FDIC regulations require First Savings Bank to adopt and maintain written policies that establish appropriate limits and standards for real estate loans. These standards, which must be consistent with safe and sound banking practices, must establish loan portfolio diversification standards, prudent underwriting standards, loan administration procedures and documentation and approval and reporting requirements. First Savings Bank is obligated to monitor conditions in its real estate markets to ensure that its standards continue to be appropriate for current market conditions. First Savings Bank's Board of Directors is required to review and approve First Savings Bank's standards at least annually. The FDIC has published guidelines for compliance with these regulations, including supervisory limitations on loan-to-value ratios for different categories of real estate loans. Under the guidelines, the aggregate amount of all loans in excess of the supervisory loan-to-value ratios should not exceed 100% of total capital and the total of all loans for commercial, agricultural, multifamily or other non-one-to-four family residential properties in excess of the supervisory loan-to-value ratios should not exceed 30% of total capital. Total capital consists of the sum of an institution's Tier 1 capital and Tier 2 capital. Loans in excess of the supervisory loan-to-value ratio limitations must be identified in First Savings Bank's records and reported at least quarterly to First Savings Bank's Board of Directors. First Savings Bank is in compliance with the record keeping and reporting requirements. As of December 31, 2012, First Savings Bank's aggregate loans in excess of the supervisory loan-to-value ratios were 12.3% of total risk-based capital and First Savings Bank's loans on construction, commercial, multifamily or other non-one-to-four family residential properties in excess of the supervisory loan-to-value ratios were 8.5% of total risk-based capital.

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’, trustees’ 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 owned by another FDIC-insured institution if certain requirements are met.

Washington state has enacted a law regarding financial institution parity. Primarily, the law affords Washington state-chartered commercial banks the same powers as Washington state-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of the DFI and the Director must authorize the requested activity. In addition, the law provides that Washington state-chartered savings banks may exercise any of the powers of Washington state-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington state-chartered commercial and savings banks with respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

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 First Savings Bank, 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 often are substantial and can exceed the value of the collateral property.

Federal Reserve System. The Federal Reserve requires that all depository institutions maintain reserves on transaction accounts and non-personal time deposits. These reserves may be in the form of cash or deposits with the regional Federal Reserve. 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 reserve requirements, as are any non-personal time deposits at a savings bank. As of December 31, 2012, First Savings Bank's vault cash exceeded its Regulation D reserve requirements.

Affiliate Transactions. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates, including their bank holding companies. Transactions deemed to be a "covered transaction" under Section 23A of the Federal Reserve Act and between a subsidiary bank and its parent company or any nonbank subsidiary of the bank holding company are limited to 10% of the subsidiary bank's capital and surplus and, with respect to the parent company and all such nonbank subsidiaries, to an aggregate of 20% of the subsidiary 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 nonaffiliates. For additional information, see "- Regulation and Supervision of First Financial Northwest - Limitations on Transactions with Affiliates" below.

Community Reinvestment Act. Banks are 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 the bank's record is made available to the public. Further, a bank's CRA performance 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 or banks that are involved in certain acquisitions by a savings and loan holding company. First Savings Bank received a "satisfactory" rating during its most recent examination.

Dividends. The amount of dividends payable by First Savings Bank to First Financial Northwest depends upon First Savings Bank's earnings and capital position, and is limited by federal and state laws. According to Washington law, First Savings Bank may not declare or pay a cash dividend on its capital stock if it