

Waterstone Financial, Inc.  
Form 10-Q  
October 30, 2015

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

Form 10-Q

T Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2015

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 001-36271

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

Maryland 90-1026709  
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

11200 W. Plank Court Wauwatosa, Wisconsin 53226  
(Address of principal executive offices) (Zip Code)

(414) 761-1000  
(Registrant's telephone number, including area code)

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 T 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes T No

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

Large accelerated filer Accelerated filer T Non-accelerated filer Smaller reporting company

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(Do not check if smaller reporting company)

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

Yes                      No      T

The number of shares outstanding of the issuer's common stock, \$0.01 par value per share, was 29,429,464 at October 29, 2015.

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WATERSTONE FINANCIAL, INC.

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## PART I — FINANCIAL INFORMATION

Item 1. Financial StatementsWATERSTONE FINANCIAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

|  | (Unaudited)   |                      |
|--|---|----------------------|
|  | September<br>30, 2015   | December<br>31, 2014 |
|  | (Dollars In Thousands,<br>except share and per<br>share data) |                      |
| Assets   |   |                      |
| Cash   | \$80,498  | 145,846              |
| Federal funds sold   | 37,391  | 21,268               |
| Interest-earning deposits in other financial institutions and other short term investments | 12,511  | 5,706                |
| Cash and cash equivalents  | 130,400   | 172,820              |
| Securities available for sale (at fair value)  | 257,536   | 273,443              |
| Loans held for sale (at fair value)  | 141,808   | 125,073              |
| Loans receivable   | 1,100,641   | 1,094,990            |
| Less: Allowance for loan losses  | 16,928  | 18,706               |
| Loans receivable, net  | 1,083,713   | 1,076,284            |
| Office properties and equipment, net   | 25,195  | 25,562               |
| Federal Home Loan Bank stock (at cost)   | 19,500  | 17,500               |
| Cash surrender value of life insurance   | 52,223  | 50,848               |
| Real estate owned, net   | 12,156  | 18,706               |
| Prepaid expenses and other assets  | 22,178  | 23,144               |
| Total assets   | \$1,744,709   | 1,783,380            |
| Liabilities and Shareholders' Equity   |   |                      |
| Liabilities:   |   |                      |
| Demand deposits  | \$96,344  | 92,162               |
| Money market and savings deposits  | 136,486   | 119,163              |
| Time deposits  | 640,325   | 652,635              |
| Total deposits   | 873,155   | 863,960              |
| Borrowings   | 434,000   | 434,000              |
| Advance payments by borrowers for taxes  | 23,839  | 4,991                |
| Other liabilities  | 23,121  | 30,192               |
| Total liabilities  | 1,354,115   | 1,333,143            |
| Shareholders' equity:  |   |                      |
| Preferred stock (par value \$.01 per share)  |   |                      |
| Authorized - 50,000,000 shares in 2015 and 50,000,000 in 2014, no shares issued            | -   | -                    |
| Common stock (par value \$.01 per share)   |   |                      |
| Authorized - 100,000,000 shares in 2015 and 100,000,000 in 2014                            |   |                      |
| Issued - 29,436,864 in 2015 and 34,420,094 in 2014   |   |                      |
| Outstanding - 29,436,864 in 2015 and 34,420,094 in 2014                                    | 294   | 344                  |
| Additional paid-in capital   | 316,460   | 313,894              |

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|  |             |           |
|--|-------------|-----------|
| Retained earnings  | 166,398     | 157,304   |
| Unearned ESOP shares   | (21,661 )   | (22,552 ) |
| Accumulated other comprehensive income, net of taxes                       | 1,228       | 1,247     |
| Cost of shares repurchased (5,581,715 shares in 2015 and 0 shares in 2014) | (72,125 )   | -         |
| Total shareholders' equity   | 390,594     | 450,237   |
| Total liabilities and shareholders' equity                                 | \$1,744,709 | 1,783,380 |

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

|  | Three months<br>ended September<br>30,   |        | Nine months<br>ended September<br>30, |        |
|--|--|--------|---------------------------------------|--------|
|  | 2015                                     | 2014   | 2015                                  | 2014   |
|  | (In Thousands, except per share amounts) |        |                                       |        |
| Interest income:   |  |        |                                       |        |
| Loans  | \$14,117                                 | 14,942 | 41,495                                | 43,178 |
| Mortgage-related securities                                    | 792                                      | 835    | 2,451                                 | 2,142  |
| Debt securities, federal funds sold and short-term investments | 886                                      | 823    | 2,609                                 | 2,474  |
| Total interest income  | 15,795                                   | 16,600 | 46,555                                | 47,794 |
| Interest expense:  |  |        |                                       |        |
| Deposits   | 1,540                                    | 1,337  | 4,251                                 | 3,522  |
| Borrowings   | 4,345                                    | 4,349  | 12,898                                | 13,048 |
| Total interest expense   | 5,885                                    | 5,686  | 17,149                                | 16,570 |
| Net interest income  | 9,910                                    | 10,914 | 29,406                                | 31,224 |
| Provision for loan losses                                      | 580                                      | 315    | 1,720                                 | 850    |
| Net interest income after provision for loan losses            | 9,330                                    | 10,599 | 27,686                                | 30,374 |
| Noninterest income:  |  |        |                                       |        |
| Service charges on loans and deposits                          | 364                                      | 317    | 1,213                                 | 904    |
| Increase in cash surrender value of life insurance             | 636                                      | 630    | 1,195                                 | 1,082  |
| Mortgage banking income  | 26,708                                   | 22,053 | 77,324                                | 58,743 |
| Gain on sale of available for sale securities                  | -  | -      | 44                                    | -      |
| Other  | 843                                      | 911    | 1,848                                 | 3,436  |
| Total noninterest income                                       | 28,551                                   | 23,911 | 81,624                                | 64,165 |
| Noninterest expenses:  |  |        |                                       |        |
| Compensation, payroll taxes, and other employee benefits       | 21,234                                   | 18,169 | 62,584                                | 51,418 |
| Occupancy, office furniture, and equipment                     | 2,292                                    | 2,577  | 7,004                                 | 7,883  |
| Advertising  | 755                                      | 678    | 2,120                                 | 2,252  |
| Data processing  | 592                                      | 582    | 1,797                                 | 1,701  |
| Communications   | 332                                      | 430    | 1,053                                 | 1,250  |
| Professional fees  | 642                                      | 441    | 1,771                                 | 1,471  |
| Real estate owned  | 646                                      | 665    | 1,875                                 | 1,918  |
| FDIC insurance premiums  | 243                                      | 336    | 851                                   | 1,046  |
| Other  | 3,050                                    | 3,152  | 9,106                                 | 9,325  |
| Total noninterest expenses                                     | 29,786                                   | 27,030 | 88,161                                | 78,264 |
| Income before income taxes                                     | 8,095                                    | 7,480  | 21,149                                | 16,275 |
| Income tax expense   | 2,896                                    | 2,715  | 7,651                                 | 5,857  |
| Net income   | \$5,199                                  | 4,765  | 13,498                                | 10,418 |
| Income per share:  |  |        |                                       |        |
| Basic  | \$0.19                                   | 0.14   | 0.45                                  | 0.31   |
| Diluted  | \$0.19                                   | 0.14   | 0.45                                  | 0.31   |
| Weighted average shares outstanding:                           |  |        |                                       |        |
| Basic  | 27,490                                   | 33,003 | 29,882                                | 33,759 |
| Diluted  | 27,795                                   | 33,232 | 30,145                                | 33,997 |

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

|   | Three months<br>ended<br>September 30,<br>2015 |        | 2014   |        | Nine months<br>ended September<br>30,<br>2015 |  | 2014 |  |
|---|--|--------|--------|--------|---|--|------|--|
|   | (In Thousands)                                 |        |        |        |   |  |      |  |
| Net income  | \$5,199  | 4,765  | 13,498 | 10,418 |   |  |      |  |
| Other comprehensive (loss) income, net of tax:  |  |        |        |        |   |  |      |  |
| Net unrealized holding (loss) gain on available for sale securities:  |  |        |        |        |   |  |      |  |
| Net unrealized holding (loss) gain arising during the period, net of tax benefit (expense) of (\$718), \$116, (\$4), (\$1,281), respectively                  | 1,114  | (180 ) | 8      | 1,984  |   |  |      |  |
| Reclassification adjustment for net (gain) loss included in net income during the period, net of tax expense (benefit) of \$0, \$0, \$17, (\$7), respectively | -  | -      | (27 )  | 10     |   |  |      |  |
| Total other comprehensive (loss) income   | 1,114  | (180 ) | (19 )  | 1,994  |   |  |      |  |
| Comprehensive income  | \$6,313  | 4,585  | 13,479 | 12,412 |   |  |      |  |

See Accompanying Notes to Unaudited Consolidated Financial Statements.



WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(Unaudited)

|   | Common Stock | Additional Paid-In       | Retained Earnings | Unearned ESOP | Accumulated Other Comprehensive Income | Treasury Shares | Cost of Shares Repurchased | Total Shareholders' Equity |           |
|---|--------------|--------------------------|-------------------|---------------|--|-----------------|----------------------------|----------------------------|-----------|
|   | Shares       | Amount<br>(In Thousands) | Capital           | Earnings      | Shares                                 | (Loss)          | Shares                     | Repurchased                |           |
| Balances at December 31, 2013                             | 31,349       | \$341                    | 110,480           | 151,195       | (854 )                                 | (1,429 )        | (45,261 )                  | -                          | 214,472   |
| Comprehensive income:                                     |              |                          |                   |               |  |                 |                            |                            |           |
| Net income  | -            | -                        | -                 | 10,418        | -                                      | -               | -                          | -                          | 10,418    |
| Other comprehensive income                                | -            | -                        | -                 | -             | -                                      | 1,994           | -                          | -                          | 1,994     |
| Total comprehensive income                                |              |                          |                   |               |  |                 |                            |                            | 12,412    |
| Purchase of ESOP Shares                                   | -            | -                        | -                 | -             | (22,884 )                              | -               | -                          | -                          | (22,884 ) |
| ESOP shares committed to be released to Plan participants | -            | -                        | 5                 | -             | 890                                    | -               | -                          | -                          | 895       |
| Cash dividend, \$0.15 per share                           | -            | -                        | -                 | (5,002 )      | -                                      | -               | -                          | -                          | (5,002 )  |
| Stock based compensation                                  | 14           | -                        | 198               | -             | -                                      | -               | -                          | -                          | 198       |
| Merger of Lamplighter, MHC                                | (23,050)     | (231)                    | 305               | -             | -                                      | -               | -                          | -                          | 74        |
| Exchange of common stock                                  | (8,299 )     | (83 )                    | 83                | -             | -                                      | -               | -                          | -                          | -         |
| Treasury stock retired                                    | -            | (27 )                    | (45,234 )         | -             | -                                      | -               | 45,261                     | -                          | -         |
| Proceeds of stock offering, net of costs                  | 34,406       | 344                      | 248,004           | -             | -                                      | -               | -                          | -                          | 248,348   |
| Balances at September 30, 2014                            | 34,420       | \$344                    | 313,841           | 156,611       | (22,848 )                              | 565             | -                          | -                          | 448,513   |

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|  |          |       |         |          |           |       |   |           |           |
|--|----------|-------|---------|----------|-----------|-------|---|-----------|-----------|
| Balances at<br>December 31,<br>2014                                      | 34,420   | \$344 | 313,894 | 157,304  | (22,552 ) | 1,247 | - | -         | 450,237   |
| Comprehensive<br>income:   |          |       |         |          |           |       |   |           |           |
| Net income   | -        | -     | -       | 13,498   | -         | -     | - | -         | 13,498    |
| Other<br>comprehensive<br>loss   | -        | -     | -       | -        | -         | (19 ) | - | -         | (19 )     |
| Total<br>comprehensive<br>income   |          |       |         |          |           |       |   |           | 13,479    |
| ESOP shares<br>committed to be<br>released to Plan<br>participants       | -        | -     | 136     | -        | 891       | -     | - | -         | 1,027     |
| Cash dividend,<br>\$0.15 per share                                       | -        | -     | -       | (4,404 ) | -         | -     | - | -         | (4,404 )  |
| Stock based<br>compensation<br>activity                                  | 599      | 6     | 96      | -        | -         | -     | - | -         | 102       |
| Stock<br>compensation<br>expense   | -        | -     | 2,334   | -        | -         | -     | - | -         | 2,334     |
| Purchase of<br>common stock<br>returned to<br>authorized but<br>unissued | (5,582 ) | (56 ) | -       | -        | -         | -     | - | (72,125 ) | (72,181 ) |
| Balances at<br>September 30,<br>2015                                     | 29,437   | \$294 | 316,460 | 166,398  | (21,661 ) | 1,228 | - | (72,125 ) | 390,594   |

See Accompanying Notes to Unaudited Consolidated Financial Statements.

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | Nine months ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2015                               | 2014        |
|   | (In Thousands)                     |             |
| Operating activities:   |                                    |             |
| Net income  | \$ 13,498                          | 10,418      |
| Adjustments to reconcile net income to net cash provided by (used) in operating activities: |                                    |             |
| Provision for loan losses   | 1,720                              | 850         |
| Provision for depreciation  | 2,337                              | 2,463       |
| Stock based compensation  | 2,334                              | 149         |
| Net amortization of premium/discount on debt and mortgage related securities                | 1,011                              | 1,215       |
| Amortization of unearned ESOP shares  | 1,027                              | 895         |
| Amortization and impairment of mortgage servicing rights                                    | 422                                | 321         |
| Gain on sale of loans held for sale   | (75,935 )                          | (52,764 )   |
| Loans originated for sale   | (1,545,098)                        | (1,256,795) |
| Proceeds on sales of loans originated for sale  | 1,604,297                          | 1,262,387   |
| Increase in accrued interest receivable   | (218 )                             | (420 )      |
| Increase in cash surrender value of life insurance  | (1,195 )                           | (1,082 )    |
| Decrease in accrued interest on deposits and borrowings                                     | (34 )                              | (46 )       |
| Increase in other liabilities   | 2,846                              | 552         |
| Increase in accrued tax receivable  | 2,591                              | 1,692       |
| Gain on sale of available for sale securities   | (44 )                              | -           |
| Net loss related to real estate owned   | 427                                | 591         |
| Gain on sale of mortgage servicing rights   | (807 )                             | (2,393 )    |
| Other   | (1,426 )                           | 9,088       |
| Net cash provided by (used in) operating activities   | 7,753                              | (22,879 )   |
| Investing activities:   |                                    |             |
| Net increase in loans receivable  | (20,868 )                          | (37,141 )   |
| Purchases of:   |                                    |             |
| Debt securities   | (10,000 )                          | (15,997 )   |
| Mortgage related securities   | (15,933 )                          | (80,837 )   |
| Certificates of deposit   | -                                  | (735 )      |
| Premises and equipment, net   | (2,042 )                           | (1,703 )    |
| Bank owned life insurance   | (180 )                             | (10,180 )   |
| FHLB stock  | (2,000 )                           | -           |
| Proceeds from:  |                                    |             |
| Principal repayments on mortgage-related securities   | 31,647                             | 20,662      |
| Maturities of debt securities   | 8,160                              | 13,020      |
| Sales of debt securities  | 1,034                              | -           |
| Sales of real estate owned  | 18,332                             | 9,579       |
| Net cash provided by (used in) investing activities   | 8,150                              | (103,332 )  |
| Financing activities:   |                                    |             |
| Net increase in deposits  | 9,195                              | 20,714      |
| Net change in borrowings  | -                                  | (21,197 )   |

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|  |            |            |
|--|------------|------------|
| Net change in advance payments by borrowers for taxes        | 9,070      | 6,911      |
| Cash dividends on common stock                               | (4,509 )   | (3,387 )   |
| Financing for purchase of ESOP                               | -          | (22,884 )  |
| Purchase of common stock returned to authorized but unissued | (72,181 )  | -          |
| Proceeds from stock option exercises                         | 102        | 49         |
| Stock offering funds returned to subscribers                 | -          | (141,882 ) |
| Net cash used in financing activities                        | (58,323 )  | (161,676 ) |
| Decrease in cash and cash equivalents                        | (42,420 )  | (287,887 ) |
| Cash and cash equivalents at beginning of period             | 172,820    | 429,169    |
| Cash and cash equivalents at end of period                   | \$ 130,400 | 141,282    |

Supplemental information:

Cash paid or credited during the period for:

|  |        |         |
|--|--------|---------|
| Income tax payments                                  | 10,234 | 2,199   |
| Interest payments                                    | 17,183 | 16,616  |
| Noncash activities:                                  |        |         |
| Loans receivable transferred to real estate owned    | 11,719 | 13,423  |
| Deposits utilized to purchase common stock           | -      | 248,422 |
| Dividends declared but not paid in other liabilities | 1,516  | 1,615   |

See Accompanying Notes to Unaudited Consolidated Financial Statements.

WATERSTONE FINANCIAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1 — Basis of Presentation

On June 6, 2013, the Board of Directors of Lamplighter Financial, MHC ("MHC") and the Board of Directors of Waterstone Financial, Inc., a federal corporation, ("Waterstone-Federal") adopted a Plan of Conversion and Reorganization (the "Plan"). Pursuant to the Plan, Waterstone Financial, Inc., a Maryland corporation, ("New Waterstone") was organized and the MHC converted from the mutual holding company form of organization to the fully public form on January 22, 2014. As part of the conversion, the MHC's ownership interest of Waterstone-Federal was offered for sale in a public offering. A total of 25,300,000 shares were sold in the offering at a price \$10.00 per share, resulting in gross proceeds of \$253.0 million. Expenses related to the offering totaled approximately \$4.7 million. The existing publicly held shares of Waterstone-Federal were exchanged for new shares of common stock of New Waterstone at a conversion ratio of 1.0973-to-one. The exchange ratio ensured that immediately after the conversion and public offering, the public shareholders of Waterstone-Federal owned the same aggregate percentage of New Waterstone common stock that they owned immediately prior to that time (excluding shares purchased in the stock offering and cash received in lieu of fractional shares). When the conversion and public offering was completed, New Waterstone became the holding company of WaterStone Bank SSB and succeeded to all of the business and operations of Waterstone-Federal and each of Waterstone-Federal and Lamplighter Financial, MHC ceased to exist. Approximately 34,405,458 shares of New Waterstone common stock were outstanding after the completion of the offering and exchange. The words "Waterstone Financial," "we" and "our" thus are intended to refer to Waterstone-Federal and its subsidiaries with respect to matters and time periods occurring on or before January 22, 2014, and to New Waterstone and its subsidiaries with respect to matters and time periods occurring thereafter.

The unaudited interim consolidated financial statements include the accounts of Waterstone Financial, Inc. (the "Company") and the Company's subsidiaries.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information, Rule 10-01 of Regulation S-X and the instructions to Form 10-Q. The financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly the financial position, results of operations, changes in shareholders' equity, and cash flows of the Company for the periods presented.

The accompanying unaudited consolidated financial statements and related notes should be read in conjunction with the Company's December 31, 2014 Annual Report on Form 10-K. Operating results for the nine months ended September 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015 or for any other period.

The preparation of the unaudited consolidated financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumptions include the allowance for loan losses, deferred income taxes and real estate owned. Actual results could differ from those estimates.

Certain prior period amounts have been reclassified to conform to current period presentation. These reclassifications did not result in any changes to previously reported net income or shareholders' equity.



## Note 2— Securities Available for Sale

The amortized cost and fair values of the Company's investment in securities available for sale follow:

|  | September 30, 2015 |                        |                         |            |
|--|--------------------|------------------------|-------------------------|------------|
|  | Amortized cost     | Gross unrealized gains | Gross unrealized losses | Fair value |
|  | (In Thousands)     |                        |                         |            |
| Mortgage-backed securities             | \$ 101,865         | 1,832                  | (123 )                  | 103,574    |
| Collateralized mortgage obligations:   |                    |                        |                         |            |
| Government sponsored enterprise issued | 56,151             | 451                    | (46 )                   | 56,556     |
| Mortgage-related securities            | 158,016            | 2,283                  | (169 )                  | 160,130    |
| Government sponsored enterprise bonds  | 3,750              | 15                     | -                       | 3,765      |
| Municipal securities                   | 72,089             | 1,228                  | (227 )                  | 73,090     |
| Other debt securities                  | 17,402             | 212                    | (500 )                  | 17,114     |
| Debt securities                        | 93,241             | 1,455                  | (727 )                  | 93,969     |
| Certificates of deposit                | 3,430              | 10                     | (3 )                    | 3,437      |
|  | \$ 254,687         | 3,748                  | (899 )                  | 257,536    |
|  |                    |                        |                         |            |
|  | December 31, 2014  |                        |                         |            |
|  | Amortized cost     | Gross unrealized gains | Gross unrealized losses | Fair value |
|  | (In Thousands)     |                        |                         |            |
| Mortgage-backed securities             | \$ 115,670         | 1,582                  | (124 )                  | 117,128    |
| Collateralized mortgage obligations:   |                    |                        |                         |            |
| Government sponsored enterprise issued | 58,821             | 320                    | (70 )                   | 59,071     |
| Mortgage-related securities            | 174,491            | 1,902                  | (194 )                  | 176,199    |
| Government sponsored enterprise bonds  | 6,750              | 2                      | (41 )                   | 6,711      |
| Municipal securities                   | 76,037             | 1,442                  | (371 )                  | 77,108     |
| Other debt securities                  | 7,404              | 159                    | (35 )                   | 7,528      |
| Debt securities                        | 90,191             | 1,603                  | (447 )                  | 91,347     |
| Certificates of deposit                | 5,880              | 17                     | -                       | 5,897      |
|  | \$ 270,562         | 3,522                  | (641 )                  | 273,443    |

The Company's mortgage-backed securities and collateralized mortgage obligations issued by government sponsored enterprises are guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. At September 30, 2015, \$94.2 million of the Company's mortgage related securities were pledged as collateral to secure repurchase agreement obligations of the Company. As of September 30, 2015, \$2.6 million of mortgage related securities were pledged as collateral to secure mortgage banking related activities. At December 31, 2014, \$98.2 million of the Company's government sponsored enterprise bonds and \$1.3 million of the Company's mortgage related securities were pledged as collateral to secure repurchase agreement obligations and mortgage banking related activities, respectively.

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The amortized cost and fair values of investment securities by contractual maturity at September 30, 2015 are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | Amortized Cost | Fair Value |
|--|----------------|------------|
|  | (In Thousands) |            |
| Debt and other securities              |                |            |
| Due within one year                    | \$5,826        | 5,895      |
| Due after one year through five years  | 18,874         | 19,090     |
| Due after five years through ten years | 43,264         | 43,486     |
| Due after ten years                    | 28,707         | 28,935     |
| Mortgage-related securities            | 158,016        | 160,130    |
|  | \$254,687      | 257,536    |

Gross unrealized losses on securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position were as follows:

|  | September 30, 2015  |                 |                     |                 |            |                 |
|--|---------------------|-----------------|---------------------|-----------------|------------|-----------------|
|  | Less than 12 months |                 | 12 months or longer |                 | Total      |                 |
|  | Fair value          | Unrealized loss | Fair value          | Unrealized loss | Fair value | Unrealized loss |
|  | (In Thousands)      |                 |                     |                 |            |                 |
| Mortgage-backed securities             | \$10,051            | (80)            | 5,953               | (43)            | 16,004     | (123)           |
| Collateralized mortgage obligations:   |                     |                 |                     |                 |            |                 |
| Government sponsored enterprise issued | 3,458               | (46)            | -                   | -               | 3,458      | (46)            |
| Municipal securities                   | 15,139              | (94)            | 5,496               | (133)           | 20,635     | (227)           |
| Other debt securities                  | 9,500               | (500)           | -                   | -               | 9,500      | (500)           |
| Certificates of Deposit                | 242                 | (3)             | -                   | -               | 242        | (3)             |
|  | \$38,390            | (723)           | 11,449              | (176)           | 49,839     | (899)           |
|  | December 31, 2014   |                 |                     |                 |            |                 |
|  | Less than 12 months |                 | 12 months or longer |                 | Total      |                 |
|  | Fair value          | Unrealized loss | Fair value          | Unrealized loss | Fair value | Unrealized loss |
|  | (In Thousands)      |                 |                     |                 |            |                 |
| Mortgage-backed securities             | \$10,537            | (13)            | 12,489              | (111)           | 23,026     | (124)           |
| Collateralized mortgage obligations:   |                     |                 |                     |                 |            |                 |
| Government sponsored enterprise issued | 23,131              | (70)            | -                   | -               | 23,131     | (70)            |
| Government sponsored enterprise bonds  | 2,739               | (11)            | 2,970               | (30)            | 5,709      | (41)            |
| Municipal securities                   | 5,671               | (19)            | 21,344              | (352)           | 27,015     | (371)           |
| Other debt securities                  | 4,977               | (35)            | -                   | -               | 4,977      | (35)            |
| Certificates of deposit                | 490                 | -               | -                   | -               | 490        | -               |
|  | \$47,545            | (148)           | 36,803              | (493)           | 84,348     | (641)           |

The Company reviews the investment securities portfolio on a quarterly basis to monitor its exposure to other-than-temporary impairment. In evaluating whether a security's decline in market value is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, financial condition of the issuer and the underlying obligors, quality of credit enhancements, volatility of the fair value of the security, the expected recovery period of the security and ratings agency evaluations. In addition the Company may also evaluate



payment structure, whether there are defaulted payments or expected defaults, prepayment speeds and the value of any underlying collateral.

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As of September 30, 2015, the Company held two municipal securities that had previously been deemed to be other-than-temporarily impaired. Both securities were issued by a tax incremental district in a municipality located in Wisconsin. During the year ended December 31, 2012, the Company received audited financial statements with respect to the municipal issuer that called into question the ability of the underlying taxing district that issued the securities to operate as a going concern. During the year ended December 31, 2012, the Company's analysis of these securities resulted in \$100,000 in credit losses were charged to earnings with respect to these two municipal securities. An additional \$17,000 credit loss that was charged to earnings during the year ended December 31, 2014 for these municipal bonds. During the year ended December 31, 2014, there were sales in the market of municipal issuer bonds at a discounted price that resulted in the Company recording additional credit losses. As of September 30, 2015, these securities had a combined amortized cost of \$198,000 and a combined estimated fair value of \$266,000.

As of September 30, 2015, the Company had 14 municipal securities and four mortgage-backed securities which had been in an unrealized loss position for twelve months or longer. These securities were determined not to be other-than-temporarily impaired as of September 30, 2015. The Company has determined that the decline in fair value of these securities is primarily attributable to an increase in market interest rates compared to the stated rates on these securities and is not attributable to credit deterioration. As the Company does not intend to sell nor is it more likely than not that it will be required to sell these securities before recovery of the amortized cost basis, these securities are not considered other-than-temporarily impaired.

Deterioration of general economic market conditions could result in the recognition of future other than temporary impairment losses within the investment portfolio and such amounts could be material to our consolidated financial statements.

During the nine months ended September 30, 2015, proceeds from the sale of securities totaled \$1.0 million and resulted in gains totaling \$44,000. The \$44,000 included in gain on sale of available for sale securities in the consolidated statements of income during the nine months ended September 30, 2015 was reclassified from accumulated other comprehensive income. There were no sales of securities during the nine months ended September 30, 2014.

The following table presents the change in other-than-temporary credit related impairment charges on securities available for sale for which a portion of the other-than-temporary impairments related to other factors was recognized in other comprehensive loss.

|   | (In<br>Thousands) |
|---|-------------------|
| Credit-related impairments on securities as of December 31, 2013  | \$ 100            |
| Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized        | -                 |
| Increase in credit-related impairments related to securities for which an other-than-temporary impairment was previously recognized | 17                |
| Reduction for sales of securities for which other-than-temporary was previously recognized  | -                 |
| Credit-related impairments on securities as of December 31, 2014  | 117               |
| Credit-related impairments related to securities for which an other- than-temporary impairment was not previously recognized        | -                 |
| Increase in credit-related impairments related to securities for which an other-than-temporary impairment was previously recognized | -                 |
| Credit-related impairments on securities as of September 30, 2015   | \$ 117            |



## Note 3 - Loans Receivable

Loans receivable at September 30, 2015 and December 31, 2014 are summarized as follows:

|                          | September<br>30, 2015 | December<br>31, 2014 |
|--------------------------|-----------------------|----------------------|
|                          | (In Thousands)        |                      |
| Mortgage loans:          |                       |                      |
| Residential real estate: |                       |                      |
| One- to four-family      | \$394,308             | 411,979              |
| Multi-family             | 526,276               | 522,281              |
| Home equity              | 26,035                | 29,207               |
| Construction and land    | 16,336                | 17,081               |
| Commercial real estate   | 113,294               | 94,771               |
| Consumer                 | 383                   | 200                  |
| Commercial loans         | 24,009                | 19,471               |
|                          | \$1,100,641           | 1,094,990            |

The Company provides several types of loans to its customers, including residential, construction, commercial and consumer loans. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to one borrower or to multiple borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. While credit risks are geographically concentrated in the Company's Milwaukee metropolitan area, there are no concentrations with individual or groups of related borrowers.

Qualifying loans receivable totaling \$853.7 million and \$844.2 million at September 30, 2015 and December 31, 2014, respectively, are pledged as collateral against \$350.0 million in outstanding Federal Home Loan Bank of Chicago advances under a blanket security agreement.

As of September 30, 2015 and December 31, 2014, there were no loans 90 or more days past due and still accruing interest.

An analysis of past due loans receivable as of September 30, 2015 and December 31, 2014 follows:

|                          | As of September 30, 2015                   |   |                          |                      |                        | Total<br>Loans |
|--------------------------|--|---|--------------------------|----------------------|------------------------|----------------|
|                          | 1-59<br>Days<br>Past<br>Due <sup>(1)</sup> | 60-89<br>Days<br>Past<br>Due <sup>(2)</sup> | 90 Days<br>or<br>Greater | Total<br>Past<br>Due | Current <sup>(3)</sup> |                |
|                          | (In Thousands)                             |   |                          |                      |                        |                |
| Mortgage loans:          |  |   |                          |                      |                        |                |
| Residential real estate: |  |   |                          |                      |                        |                |
| One- to four-family      | \$1,726                                    | 456   | 8,346                    | 10,528               | 383,780                | 394,308        |
| Multi-family             | 797  | -   | 3,497                    | 4,294                | 521,982                | 526,276        |
| Home equity              | 64   | 99  | 144                      | 307                  | 25,728                 | 26,035         |
| Construction and land    | -  | -   | 304                      | 304                  | 16,032                 | 16,336         |
| Commercial real estate   | 148  | -   | 77                       | 225                  | 113,069                | 113,294        |
| Consumer                 | -  | -   | -                        | -                    | 383                    | 383            |
| Commercial loans         | 4  | -   | -                        | 4                    | 24,005                 | 24,009         |

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Total \$2,739 555 12,368 15,662 1,084,979 1,100,641

As of December 31, 2014

|                          | 1-59<br>Days<br>Past<br>Due <sup>(1)</sup> | 60-89<br>Days<br>Past<br>Due <sup>(2)</sup> | 90 Days<br>or<br>Greater | Total<br>Past<br>Due | Current <sup>(3)</sup> | Total<br>Loans |
|--------------------------|--|---|--------------------------|----------------------|------------------------|----------------|
| (In Thousands)           |  |   |                          |                      |                        |                |
| Mortgage loans:          |  |   |                          |                      |                        |                |
| Residential real estate: |  |   |                          |                      |                        |                |
| One- to four-family      | \$3,767                                    | 3,743                                       | 12,196                   | 19,706               | 392,273                | 411,979        |
| Multi-family             | 462  | 280   | 11,092                   | 11,834               | 510,447                | 522,281        |
| Home equity              | 268  | 153   | 250                      | 671                  | 28,536                 | 29,207         |
| Construction and land    | 90   | -   | 362                      | 452                  | 16,629                 | 17,081         |
| Commercial real estate   | 225  | -   | 947                      | 1,172                | 93,599                 | 94,771         |
| Consumer                 | -  | -   | -                        | -                    | 200                    | 200            |
| Commercial loans         | 34   | -   | 265                      | 299                  | 19,172                 | 19,471         |
| Total                    | \$4,846                                    | 4,176                                       | 25,112                   | 34,134               | 1,060,856              | 1,094,990      |

<sup>(1)</sup> Includes \$1.1 million and \$1.6 million at September 30, 2015 and December 31, 2014, respectively, which are on non-accrual status.

<sup>(2)</sup> Includes \$386,000 and \$795,000 at September 30, 2015 and December 31, 2014, respectively, which are on non-accrual status.

<sup>(3)</sup> Includes \$8.0 million and \$10.5 million at September 30, 2015 and December 31, 2014, respectively, which are on non-accrual status.

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A summary of the activity for the nine months ended September 30, 2015 and 2014 in the allowance for loan losses follows:

|                                      | One- to<br>Four-<br>Family<br>(In Thousands) | Multi-Family | Home<br>Equity | Construction<br>and Land | Commercial<br>Real<br>Estate | Consumer | Commercial | Total    |
|--------------------------------------|--|--------------|----------------|--------------------------|------------------------------|----------|------------|----------|
| Nine months ended September 30, 2015 |  |              |                |                          |                              |          |            |          |
| Balance at beginning of period       | \$9,877                                      | 5,358        | 422            | 687                      | 1,951                        | 8        | 403        | 18,706   |
| Provision (credit) for loan losses   | 1,032  | 615          | (5 )           | 157                      | (204 )                       | (2 )     | 127        | 1,720    |
| Charge-offs                          | (3,212 )                                     | (1,501 )     | (72 )          | (84 )                    | (45 )                        | -        | -          | (4,914 ) |
| Recoveries                           | 436  | 789          | 101            | 45                       | 40                           | 5        | -          | 1,416    |
| Balance at end of period             | \$8,133                                      | 5,261        | 446            | 805                      | 1,742                        | 11       | 530        | 16,928   |
| Nine months ended September 30, 2014 |  |              |                |                          |                              |          |            |          |
| Balance at beginning of period       | \$11,549                                     | 7,211        | 1,807          | 1,613                    | 1,402                        | 34       | 648        | 24,264   |
| Provision (credit) for loan losses   | (1,540 )                                     | 2,897        | (1,098)        | 29                       | 476                          | (26 )    | 112        | 850      |
| Charge-offs                          | (1,900 )                                     | (3,462 )     | (191 )         | (418 )                   | (186 )                       | (5 )     | (293 )     | (6,455 ) |
| Recoveries                           | 1,652  | 23           | 11             | 63                       | 23                           | 5        | 3          | 1,780    |
| Balance at end of period             | \$9,761                                      | 6,669        | 529            | 1,287                    | 1,715                        | 8        | 470        | 20,439   |

A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of September 30, 2015 follows:

|  | One- to<br>Four-<br>Family<br>(In Thousands) | Multi-<br>Family | Home<br>Equity | Construction<br>and Land | Commercial<br>Real<br>Estate | Consumer | Commercial | Total     |
|--|--|------------------|----------------|--------------------------|------------------------------|----------|------------|-----------|
| Allowance related to loans individually evaluated for impairment | \$1,146                                      | 637              | 116            | 9                        | 158                          | -        | 4          | 2,070     |
| Allowance related to loans collectively evaluated for impairment | 6,987  | 4,624            | 330            | 796                      | 1,584                        | 11       | 526        | 14,858    |
| Balance at end of period   | \$8,133                                      | 5,261            | 446            | 805                      | 1,742                        | 11       | 530        | 16,928    |
| Loans individually evaluated for impairment                      | \$20,874                                     | 7,580            | 413            | 1,986                    | 2,436                        | -        | 31         | 33,320    |
| Loans collectively evaluated for impairment                      | 373,434                                      | 518,696          | 25,622         | 14,350                   | 110,858                      | 383      | 23,978     | 1,067,321 |
| Total gross loans  | \$394,308                                    | 526,276          | 26,035         | 16,336                   | 113,294                      | 383      | 24,009     | 1,100,641 |

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A summary of the allowance for loan loss for loans evaluated individually and collectively for impairment by collateral class as of December 31, 2014 follows:

|  | One- to<br>Four-<br>Family<br>(In Thousands) | Multi-<br>Family | Home<br>Equity | Construction<br>and Land | Commercial<br>Real<br>Estate | Consumer | Commercial | Total     |
|--|--|------------------|----------------|--------------------------|------------------------------|----------|------------|-----------|
| Allowance related to loans individually evaluated for impairment | \$2,386                                      | 731              | 63             | 13                       | 526                          | -        | 7          | 3,726     |
| Allowance related to loans collectively evaluated for impairment | 7,491  | 4,627            | 359            | 674                      | 1,425                        | 8        | 396        | 14,980    |
| Balance at end of period   | \$9,877                                      | 5,358            | 422            | 687                      | 1,951                        | 8        | 403        | 18,706    |
| Loans individually evaluated for impairment                      | \$29,509                                     | 15,562           | 589            | 2,266                    | 3,077                        | -        | 299        | 51,302    |
| Loans collectively evaluated for impairment                      | 382,470                                      | 506,719          | 28,618         | 14,815                   | 91,694                       | 200      | 19,172     | 1,043,688 |
| Total gross loans  | \$411,979                                    | 522,281          | 29,207         | 17,081                   | 94,771                       | 200      | 19,471     | 1,094,990 |

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The following table presents information relating to the Company's internal risk ratings of its loans receivable as of September 30, 2015 and December 31, 2014:

|                          | One- to<br>Four-<br>Family<br>(In Thousands) | Multi-Family | Home<br>Equity | Construction<br>and Land | Commercial<br>Real Estate | Consumer | Commercial | Total     |
|--------------------------|--|--------------|----------------|--------------------------|---------------------------|----------|------------|-----------|
| At September 30,<br>2015 |  |              |                |                          |                           |          |            |           |
| Substandard              | \$21,921                                     | 5,411        | 594            | 1,986                    | 2,436                     | -        | 31         | 32,379    |
| Watch                    | 7,902  | 4,578        | 284            | 975                      | 2,301                     | -        | 1,867      | 17,907    |
| Pass                     | 364,485                                      | 516,287      | 25,157         | 13,375                   | 108,557                   | 383      | 22,111     | 1,050,355 |
|                          | \$394,308                                    | 526,276      | 26,035         | 16,336                   | 113,294                   | 383      | 24,009     | 1,100,641 |
| At December 31,<br>2014  |  |              |                |                          |                           |          |            |           |
| Substandard              | \$28,945                                     | 12,638       | 624            | 2,266                    | 3,077                     | -        | 299        | 47,849    |
| Watch                    | 10,779                                       | 7,070        | 278            | 1,377                    | 2,186                     | -        | 840        | 22,530    |
| Pass                     | 372,255                                      | 502,573      | 28,305         | 13,438                   | 89,508                    | 200      | 18,332     | 1,024,611 |
|                          | \$411,979                                    | 522,281      | 29,207         | 17,081                   | 94,771                    | 200      | 19,471     | 1,094,990 |

Factors that are important to managing overall credit quality include sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an allowance for loan losses, and sound non-accrual and charge-off policies. Our underwriting policies require an officers' loan committee to review and approve all loans in excess of \$500,000. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we maintain an independent loan review system under which our credit management personnel review non-owner occupied one- to four-family, multi-family, construction and land, commercial real estate and commercial loans that individually, or as part of an overall borrower relationship, exceed \$1.0 million in potential exposure. Loans meeting these criteria are reviewed on an annual basis, or more frequently if the loan renewal is less than one year. With respect to loans subject to the annual review, the review process is contingent on the receipt of updated financial information from the borrower. To the extent that updated information is not received on a timely basis, the review is deferred and the credit is monitored until such time as the updated financial information is obtained. With respect to this review process, management has determined that pass loans include loans that exhibit acceptable financial statements, cash flow and leverage. Watch loans have potential weaknesses that deserve management's attention and, if left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the credit. Substandard loans are considered inadequately protected by the current net worth and paying capacity of the obligor or the collateral pledged. These loans generally have a well-defined weakness that may jeopardize liquidation of the debt and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Finally, a loan is considered to be impaired when it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. Management has determined that all non-accrual loans and loans modified under troubled debt restructurings meet the definition of an impaired loan.

The Company's procedures dictate that an updated valuation must be obtained with respect to underlying collateral at the time a loan is deemed impaired. Updated valuations may also be obtained upon transfer from loans receivable to real estate owned based upon the age of the prior appraisal, changes in market conditions or known changes to the physical condition of the property.

Estimated fair values are reduced to account for sales commissions, broker fees, unpaid property taxes and additional selling expenses to arrive at an estimated net realizable value. The adjustment factor is based upon the Company's actual experience with respect to sales of real estate owned over the prior two years. An additional adjustment factor is



applied by appraisal vintage to account for downward market pressure since the date of appraisal. The additional adjustment factor is based upon relevant sales data available for our general operating market as well as company-specific historical net realizable values as compared to the most recent appraisal prior to disposition.

With respect to multi-family income-producing real estate, appraisals are reviewed and estimated collateral values are adjusted by updating significant appraisal assumptions to reflect current real estate market conditions. Significant assumptions reviewed and updated include the capitalization rate, rental income and operating expenses. These adjusted assumptions are based upon recent appraisals received on similar properties as well as on actual experience related to real estate owned and currently under Company management.

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The following tables present data on impaired loans at September 30, 2015 and December 31, 2014.

|                                | As of or for the Nine Months Ended September 30, 2015        |         |                           |                                   |                  |       |
|--------------------------------|--|---------|---------------------------|-----------------------------------|------------------|-------|
|                                | Recorded Unpaid<br>Investment<br>Principal<br>(In Thousands) | Reserve | Cumulative<br>Charge-Offs | Average<br>Recorded<br>Investment | Interest<br>Paid |       |
| Total Impaired with Reserve    |  |         |                           |                                   |                  |       |
| One- to four-family            | \$5,842  | 6,025   | 1,146                     | 183                               | 6,011            | 216   |
| Multi-family                   | 2,098  | 2,200   | 637                       | 102                               | 2,176            | 30    |
| Home equity                    | 172  | 172     | 116                       | -                                 | 175              | 8     |
| Construction and land          | 212  | 362     | 9                         | 150                               | 245              | -     |
| Commercial real estate         | 1,130  | 1,539   | 158                       | 409                               | 100              | 44    |
| Consumer                       | -  | -       | -                         | -                                 | -                | -     |
| Commercial                     | 4  | 4       | 4                         | -                                 | 6                | 1     |
|                                | 9,458  | 10,302  | 2,070                     | 844                               | 8,713            | 299   |
| Total Impaired with no Reserve |  |         |                           |                                   |                  |       |
| One- to four-family            | 15,032   | 18,659  | -                         | 3,627                             | 16,316           | 471   |
| Multi-family                   | 5,482  | 7,483   | -                         | 2,001                             | 5,585            | 197   |
| Home equity                    | 241  | 255     | -                         | 14                                | 244              | 5     |
| Construction and land          | 1,774  | 1,774   | -                         | -                                 | 1,912            | 51    |
| Commercial real estate         | 1,306  | 1,306   | -                         | -                                 | 1,306            | 48    |
| Consumer                       | -  | -       | -                         | -                                 | -                | -     |
| Commercial                     | 27   | 27      | -                         | -                                 | 31               | 1     |
|                                | 23,862   | 29,504  | -                         | 5,642                             | 25,394           | 773   |
| Total Impaired                 |  |         |                           |                                   |                  |       |
| One- to four-family            | 20,874   | 24,684  | 1,146                     | 3,810                             | 22,327           | 687   |
| Multi-family                   | 7,580  | 9,683   | 637                       | 2,103                             | 7,761            | 227   |
| Home equity                    | 413  | 427     | 116                       | 14                                | 419              | 13    |
| Construction and land          | 1,986  | 2,136   | 9                         | 150                               | 2,157            | 51    |
| Commercial real estate         | 2,436  | 2,845   | 158                       | 409                               | 1,406            | 92    |
| Consumer                       | -  | -       | -                         | -                                 | -                | -     |
| Commercial                     | 31   | 31      | 4                         | -                                 | 37               | 2     |
|                                | \$33,320   | 39,806  | 2,070                     | 6,486                             | 34,107           | 1,072 |

|                                | As of or for the Year Ended December 31, 2014                |         |                           |                                   |                  |     |
|--------------------------------|--|---------|---------------------------|-----------------------------------|------------------|-----|
|                                | Recorded Unpaid<br>Investment<br>Principal<br>(In Thousands) | Reserve | Cumulative<br>Charge-Offs | Average<br>Recorded<br>Investment | Interest<br>Paid |     |
| Total Impaired with Reserve    |  |         |                           |                                   |                  |     |
| One- to four-family            | \$11,864   | 13,345  | 2,386                     | 1,481                             | 15,982           | 515 |
| Multi-family                   | 7,438  | 10,285  | 731                       | 2,847                             | 12,720           | 177 |
| Home equity                    | 144  | 144     | 63                        | -                                 | 195              | 7   |
| Construction and land          | 47   | 61      | 13                        | 14                                | 63               | -   |
| Commercial real estate         | 2,984  | 3,544   | 526                       | 560                               | 4,211            | 128 |
| Consumer                       | -  | -       | -                         | -                                 | -                | -   |
| Commercial                     | 7  | 7       | 7                         | -                                 | 12               | 1   |
|                                | 22,484   | 27,386  | 3,726                     | 4,902                             | 33,183           | 828 |
| Total Impaired with no Reserve |  |         |                           |                                   |                  |     |
| One- to four-family            | 17,645   | 19,795  | -                         | 2,150                             | 23,215           | 860 |

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|                        |          |        |       |       |        |       |
|------------------------|----------|--------|-------|-------|--------|-------|
| Multi-family           | 8,124    | 9,364  | -     | 1,240 | 12,693 | 439   |
| Home equity            | 445      | 445    | -     | -     | 554    | 15    |
| Construction and land  | 2,219    | 2,332  | -     | 113   | 3,379  | 97    |
| Commercial real estate | 93       | 93     | -     | -     | 126    | 4     |
| Consumer               | -        | -      | -     | -     | -      | -     |
| Commercial             | 292      | 535    | -     | 243   | 470    | 2     |
|                        | 28,818   | 32,564 | -     | 3,746 | 40,437 | 1,417 |
| Total Impaired         |          |        |       |       |        |       |
| One- to four-family    | 29,509   | 33,140 | 2,386 | 3,631 | 39,197 | 1,375 |
| Multi-family           | 15,562   | 19,649 | 731   | 4,087 | 25,413 | 616   |
| Home equity            | 589      | 589    | 63    | -     | 749    | 22    |
| Construction and land  | 2,266    | 2,393  | 13    | 127   | 3,442  | 97    |
| Commercial real estate | 3,077    | 3,637  | 526   | 560   | 4,337  | 132   |
| Consumer               | -        | -      | -     | -     | -      | -     |
| Commercial             | 299      | 542    | 7     | 243   | 482    | 3     |
|                        | \$51,302 | 59,950 | 3,726 | 8,648 | 73,620 | 2,245 |

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The difference between a loan's recorded investment and the unpaid principal balance represents a partial charge-off resulting from a confirmed loss when the value of the collateral securing the loan is below the loan balance and management's assessment that the full collection of the loan balance is not likely.

When a loan is considered impaired, interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

The determination as to whether an allowance is required with respect to impaired loans is based upon an analysis of the value of the underlying collateral and/or the borrower's intent and ability to make all principal and interest payments in accordance with contractual terms. The evaluation process is subject to the use of significant estimates and actual results could differ from estimates. This analysis is primarily based upon third party appraisals and/or a discounted cash flow analysis. In those cases in which no allowance has been provided for an impaired loan, the Company has determined that the estimated value of the underlying collateral exceeds the remaining outstanding balance of the loan. Of the total \$23.9 million of impaired loans as of September 30, 2015 for which no allowance has been provided, \$5.6 million in charge-offs have been recorded to reduce the unpaid principal balance to an amount that is commensurate with the loans' net realizable value, using the estimated fair value of the underlying collateral. To the extent that further deterioration in property values continues, the Company may have to reevaluate the sufficiency of the collateral servicing these impaired loans resulting in additional provisions to the allowance for loans losses or charge-offs.

At September 30, 2015, total impaired loans includes \$17.9 million of troubled debt restructurings. Troubled debt restructurings involve granting concessions to a borrower experiencing financial difficulty by modifying the terms of the loan in an effort to avoid foreclosure. The vast majority of debt restructurings include a modification of terms to allow for an interest only payment and/or reduction in interest rate. The restructured terms are typically in place for six to twelve months. At December 31, 2014, total impaired loans included \$26.1 million of troubled debt restructurings.

The following presents data on troubled debt restructurings:

|                        | As of September 30, 2015 |        |              |        |          |        |
|------------------------|--------------------------|--------|--------------|--------|----------|--------|
|                        | Accruing                 |        | Non-accruing |        | Total    |        |
|                        | Amount                   | Number | Amount       | Number | Amount   | Number |
|                        | (dollars in thousands)   |        |              |        |          |        |
| One- to four-family    | \$3,905                  | 4      | \$5,810      | 45     | \$9,715  | 49     |
| Multi-family           | 2,795                    | 2      | 2,300        | 7      | 5,095    | 9      |
| Home equity            | -                        | -      | 98           | 1      | 98       | 1      |
| Construction and land  | 1,636                    | 2      | -            | -      | 1,636    | 2      |
| Commercial real estate | 1,306                    | 1      | 77           | 1      | 1,383    | 2      |
|                        | \$9,642                  | 9      | \$8,285      | 54     | \$17,927 | 63     |
|                        | As of December 31, 2014  |        |              |        |          |        |
|                        | Accruing                 |        | Non-accruing |        | Total    |        |
|                        | Amount                   | Number | Amount       | Number | Amount   | Number |
|                        | (dollars in thousands)   |        |              |        |          |        |
| One- to four-family    | \$4,724                  | 8      | \$10,233     | 55     | \$14,957 | 63     |

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|                        |          |    |          |    |          |    |
|------------------------|----------|----|----------|----|----------|----|
| Multi-family           | 2,923    | 2  | 4,797    | 7  | 7,720    | 9  |
| Home equity            | -        | -  | 98       | 1  | 98       | 1  |
| Construction and land  | 1,866    | 2  | -        | -  | 1,866    | 2  |
| Commercial real estate | 1,306    | 1  | 170      | 1  | 1,476    | 2  |
|                        | \$10,819 | 13 | \$15,298 | 64 | \$26,117 | 77 |

At September 30, 2015, \$17.9 million in loans had been modified in troubled debt restructurings and \$8.3 million of these loans were included in the non-accrual loan total. The remaining \$9.6 million, while meeting the internal requirements for modification in a troubled debt restructuring, were current with respect to payments under their original loan terms at the time of the restructuring and thus, continued to be included with accruing loans. Provided these loans perform in accordance with the modified terms, they will continue to be accounted for on an accrual basis.

All loans that have been modified in a troubled debt restructuring are considered to be impaired. As such, an analysis has been performed with respect to all of these loans to determine the need for a valuation reserve. When a loan is expected to perform in accordance with the restructured terms and ultimately return to and perform under contract terms, a valuation allowance is established for an amount equal to the excess of the present value of the expected future cash flows under the original contract terms as compared with the modified terms, including an estimated default rate. When there is doubt as to the borrower's ability to perform under the restructured terms or ultimately return to and perform under market terms, a valuation allowance is established equal to the impairment when the carrying amount exceeds fair value of the underlying collateral. As a result of the impairment analysis, a \$1.0 million valuation allowance has been established as of September 30, 2015 with respect to the \$17.9 million in troubled debt restructurings. As of December 31, 2014, a \$1.5 million valuation allowance had been established with respect to the \$26.1 million in troubled debt restructurings.

After a troubled debt restructuring reverts to market terms, a minimum of six consecutive contractual payments must be received prior to consideration for a return to accrual status. If an updated credit department review indicates no other evidence of elevated credit risk, the loan is returned to accrual status at that time.

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The following presents troubled debt restructurings by concession type:

|  | As of September 30, 2015                     |        |            |        |          |        |
|--|--|--------|------------|--------|----------|--------|
|  | Performing in accordance with modified terms |        | In Default |        | Total    |        |
|  | Amount                                       | Number | Amount     | Number | Amount   | Number |
|  | (dollars in thousands)                       |        |            |        |          |        |
| Interest reduction and principal forbearance | \$15,031                                     | 34     | \$77       | 1      | \$15,108 | 35     |
| Principal forbearance                        | 339  | 2      | -          | -      | 339      | 2      |
| Interest reduction                           | 2,480  | 26     | -          | -      | 2,480    | 26     |
|  | \$17,850                                     | 62     | \$77       | 1      | \$17,927 | 63     |

|  | As of December 31, 2014                      |        |            |        |          |        |
|--|--|--------|------------|--------|----------|--------|
|  | Performing in accordance with modified terms |        | In Default |        | Total    |        |
|  | Amount                                       | Number | Amount     | Number | Amount   | Number |
|  | (dollars in thousands)                       |        |            |        |          |        |
| Interest reduction and principal forbearance | \$15,306                                     | 36     | \$2,014    | 7      | \$17,320 | 43     |
| Principal forbearance                        | 490  | 3      | 2,632      | 1      | 3,122    | 4      |
| Interest reduction                           | 4,875  | 11     | 800        | 19     | 5,675    | 30     |
|  | \$20,671                                     | 50     | \$5,446    | 27     | \$26,117 | 77     |

The following presents data on troubled debt restructurings:

|   | For the three months ended September 30, 2015 |        | For the three months ended September 30, 2014 |        |
|---|---|--------|---|--------|
|   | Amount  | Number | Amount  | Number |
|   | (dollars in thousands)                        |        |   |        |
| Loans modified as a troubled debt restructure |   |        |   |        |
| One- to four-family                           | \$117   | 2      | \$166   | 2      |
| Multi family                                  | 799   | 2      | 520   | 3      |
| Commercial real estate                        | -   | -      | 1,306   | 1      |
|   | \$916   | 4      | \$1,992                                       | 6      |

There were no troubled debt restructurings within the past twelve months for which there was a default during the three months ended September 30, 2015 or September 30, 2014.

The following presents data on troubled debt restructurings:

|   | For the nine months ended September 30, 2015 |        | For the nine months ended September 30, 2014 |        |
|---|--|--------|--|--------|
|   | Amount                                       | Number | Amount                                       | Number |
|   | (dollars in thousands)                       |        |  |        |
| Loans modified as a troubled debt restructure |  |        |  |        |

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|                        |       |   |         |    |
|------------------------|-------|---|---------|----|
| One- to four-family    | \$188 | 3 | \$3,938 | 15 |
| Multi family           | 799   | 2 | 1,117   | 5  |
| Home equity            | -     | - | 98      | 1  |
| Commercial real estate | -     | - | 1,306   | 1  |
|                        | \$987 | 5 | \$6,459 | 22 |

There were no troubled debt restructurings within the past twelve months for which there was a default during the nine months ended September 30, 2015 or September 30, 2014.

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The following table presents data on non-accrual loans as of September 30, 2015 and December 31, 2014:

|   | September<br>30,<br>2015  |   | December<br>31, 2014 |   |
|---|---------------------------|---|----------------------|---|
|   | (Dollars in<br>Thousands) |   |                      |   |
| Non-accrual loans:                                |                           |   |                      |   |
| Residential                                       |                           |   |                      |   |
| One- to four-family                               | \$ 16,051                 |   | 23,918               |   |
| Multi-family                                      | 4,785                     |   | 12,001               |   |
| Home equity                                       | 313                       |   | 445                  |   |
| Construction and land                             | 350                       |   | 401                  |   |
| Commercial real estate                            | 321                       |   | 947                  |   |
| Commercial  | 31                        |   | 299                  |   |
| Consumer  | -                         |   | -                    |   |
| Total non-accrual loans                           | \$ 21,851                 |   | 38,011               |   |
| Total non-accrual loans to total loans receivable | 1.99                      | % | 3.47                 | % |
| Total non-accrual loans to total assets           | 1.25                      | % | 2.13                 | % |

Note 4— Real Estate Owned

Real estate owned is summarized as follows:

|                                      | September<br>30,<br>2015 |  | December<br>31, 2014 |  |
|--------------------------------------|--------------------------|--|----------------------|--|
|                                      | (In Thousands)           |  |                      |  |
| One- to four-family                  | \$ 6,109                 |  | 10,896               |  |
| Multi-family                         | 1,214                    |  | 2,210                |  |
| Construction and land                | 5,206                    |  | 5,400                |  |
| Commercial real estate               | 300                      |  | 300                  |  |
| Total real estate owned              | 12,829                   |  | 18,806               |  |
| Valuation allowance at end of period | (673 )                   |  | (100 )               |  |
| Total real estate owned, net         | \$ 12,156                |  | 18,706               |  |

The following table presents the activity in the Company's real estate owned:

|  | Nine months<br>ended September<br>30,<br>2015 |  | 2014    |  |
|--|---|--|---------|--|
|  | (In Thousands)                                |  |         |  |
| Real estate owned at beginning of the period | \$ 18,706                                     |  | 22,663  |  |
| Transferred from loans receivable            | 11,719  |  | 13,423  |  |
| Sales (net of gains / losses)                | (17,265)                                      |  | (9,224) |  |
| Write downs                                  | (1,522 )                                      |  | (1,007) |  |
| Other  | 518   |  | (18 )   |  |
| Real estate owned at the end of the period   | \$ 12,156                                     |  | 25,837  |  |





## Note 5— Mortgage Servicing Rights

The following table presents the activity in the Company's mortgage servicing rights:

|  | Nine months<br>ended September<br>30, |         |
|--|---------------------------------------|---------|
|  | 2015                                  | 2014    |
|  | (In Thousands)                        |         |
| Mortgage servicing rights at beginning of the period | \$2,521                               | 3,377   |
| Additions  | 3,149                                 | 3,084   |
| Amortization   | (412 )                                | (321 )  |
| Sales  | (4,260)                               | (4,602) |
| Mortgage servicing rights at end of the period       | 998                                   | 1,538   |
| Valuation allowance at end of period                 | (20 )                                 | -       |
| Mortgage servicing rights at end of the period, net  | \$978                                 | 1,538   |

During the nine months ended September 30, 2015, \$1.6 billion in residential loans were originated for sale. During the same period, sales of loans held for sale totaled \$1.5 billion, generating mortgage banking income of \$77.3 million. The unpaid principal balance of loans serviced for others was \$122.8 million and \$308.1 million at September 30, 2015 and December 31, 2014 respectively. These loans are not reflected in the consolidated statements of financial condition.

During the nine months ended September 30, 2015, the Company sold mortgage servicing rights related to \$552.4 million in loans receivable and with a book value of \$4.3 million for \$5.1 million resulting in a gain on sale of \$807,000. During the nine months ended September 30, 2014, the Company sold mortgage servicing rights related to \$713.0 million in loans receivable and with a book value of \$4.6 million for \$7.0 million resulting in a gain on sale of \$2.4 million.

The following table shows the estimated future amortization expense for mortgage servicing rights for the periods indicated:

|  | (In<br>Thousands) |
|--|-------------------|
| Estimate for the period ended December 31: |                   |
| 2015                                       | \$ 54             |
| 2016                                       | 146               |
| 2017                                       | 133               |
| 2018                                       | 120               |
| 2019                                       | 107               |
| Thereafter                                 | 418               |
| Total                                      | \$ 978            |

## Note 6— Deposits

At September 30, 2015 and December 31, 2014, time deposits with balances greater than \$250,000 amount to \$36.2 million and \$34.6 million, respectively.

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A summary of the contractual maturities of time deposits at September 30, 2015 is as follows:

|                                   | (In<br>Thousands) |
|-----------------------------------|-------------------|
| Within one year                   | \$ 443,190        |
| More than one to two years        | 173,708           |
| More than two to three years      | 16,454            |
| More than three to four years     | 2,540             |
| More than four through five years | 4,433             |
|                                   | \$ 640,325        |

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## Note 7— Borrowings

Borrowings consist of the following:

|  | September 30, 2015     |        | December 31, 2014 |        |
|--|------------------------|--------|-------------------|--------|
|  | Weighted               |        | Weighted          |        |
|  | Average                |        | Average           |        |
|  | Balance                | Rate   | Balance           | Rate   |
|  | (Dollars in Thousands) |        |                   |        |
| Long term:   |                        |        |                   |        |
| Federal Home Loan Bank, Chicago advances maturing: |                        |        |                   |        |
| 2016   | \$220,000              | 4.34 % | 220,000           | 4.34 % |
| 2017   | 65,000                 | 3.19 % | 65,000            | 3.19 % |
| 2018   | 65,000                 | 2.97 % | 65,000            | 2.97 % |
| Repurchase agreements maturing                     | 2017 84,000            | 3.96 % | 84,000            | 3.96 % |
|  | \$434,000              | 3.89 % | 434,000           | 3.89 % |

The \$220.0 million in advances due in 2016 consists of eight advances with fixed rates ranging from 4.01% to 4.82% callable quarterly until maturity.

The \$65.0 million in advances due in 2017 consists of three advances with fixed rates ranging from 3.09% to 3.46% callable quarterly until maturity.

The \$65.0 million in advances due in 2018 consists of three advances with fixed rates ranging from 2.73% to 3.11% callable quarterly until maturity.

The \$84.0 million in repurchase agreements have fixed rates ranging from 2.89% to 4.31% callable quarterly until their maturity in 2017. The repurchase agreements are collateralized by securities available for sale with an estimated fair value of \$94.2 million at September 30, 2015 and \$98.2 million at December 31, 2014.

The Company selects loans that meet underwriting criteria established by the Federal Home Loan Bank of Chicago ("FHLBC") as collateral for outstanding advances. The Company's borrowings from the FHLBC are limited to 80% of the carrying value of unencumbered one- to four-family mortgage loans, 51% of the carrying value of home equity loans and 75% of the carrying value of multi-family loans. In addition, these advances are collateralized by FHLBC stock of \$19.5 million at September 30, 2015 and \$17.5 million at December 31, 2014. In the event of prepayment, the Company is obligated to pay all remaining contractual interest on the advance.

## Note 8 – Regulatory Capital

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements, or overall financial performance deemed by the regulators to be inadequate, can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities, and certain off-balance-sheet items, as calculated under regulatory accounting practices. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

As disclosed in the Company's Form 10-K filed with the Securities and Exchange Commission, in July 2013, the Federal Reserve Board and the FDIC issued final rules implementing the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The rules revise minimum capital requirements and adjust prompt corrective action thresholds. The final rules revise the regulatory capital elements, add a new common equity Tier I capital ratio, increase the minimum Tier 1 capital ratio requirements and implement a new capital conservation buffer. The rules also permit certain banking organizations to retain, through a one-time election, the existing treatment for accumulated other comprehensive income. The Company and the Bank have made the election to retain the existing treatment for accumulated other comprehensive income. The final rules took effect for the Company and the Bank on January 1, 2015, subject to a transition period for certain parts of the rules.

The table below includes the new regulatory capital ratio requirements that became effective on January 1, 2015. Beginning in 2016, an additional capital conservation buffer will be added to the minimum requirements for capital adequacy purposes, subject to a three year phase-in period. The capital conservation buffer will be fully phased-in on January 1, 2019 at 2.5 percent. A banking organization with a conservation buffer of less than 2.5 percent (or the required phase-in amount in years prior to 2019) will be subject to limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At the present time, the ratios for the Company and the Bank are sufficient to meet the fully phased-in conservation buffer.

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The actual and required capital amounts and ratios for the Bank as of September 30, 2015 and December 31, 2014 are presented in the table below:

|  | September 30, 2015 |        |                               |       | To Be Well-Capitalized Under Prompt Corrective Action Provisions |       |        |       |
|--|--------------------|--------|-------------------------------|-------|--|-------|--------|-------|
|  | Actual             |        | For Capital Adequacy Purposes |       | Amount   |       | Ratio  |       |
|  | Amount             | Ratio  | Amount                        | Ratio | Amount   | Ratio | Amount | Ratio |
| (Dollars In Thousands)                                 |                    |        |                               |       |  |       |        |       |
| Total capital (to risk-weighted assets)                |                    |        |                               |       |  |       |        |       |
| Consolidated Waterstone Financial , Inc.               | \$403,553          | 34.17% | \$94,478                      | 8.00% | N/   | A     | N/     | A     |
| WaterStone Bank  | 370,804            | 31.53% | 94,092                        | 8.00% | 117,615  |       | 10.00% |       |
| Tier I capital (to risk-weighted assets)               |                    |        |                               |       |  |       |        |       |
| Consolidated Waterstone Financial , Inc.               | 388,765            | 32.92% | 70,859                        | 6.00% | N/   | A     | N/     | A     |
| WaterStone Bank  | 356,075            | 30.27% | 70,569                        | 6.00% | 94,092   |       | 8.00%  |       |
| Common Equity Tier 1 Capital (to risk-weighted assets) |                    |        |                               |       |  |       |        |       |
| Consolidated Waterstone Financial , Inc.               | 388,765            | 32.92% | 53,144                        | 4.50% | N/   | A     | N/     | A     |
| WaterStone Bank  | 356,075            | 30.27% | 52,927                        | 4.50% | 76,450   |       | 6.50%  |       |
| Tier I capital (to average assets)                     |                    |        |                               |       |  |       |        |       |
| Consolidated Waterstone Financial , Inc.               | 388,765            | 22.32% | 69,658                        | 4.00% | N/   | A     | N/     | A     |
| WaterStone Bank  | 356,075            | 20.45% | 69,656                        | 4.00% | 87,071   |       | 5.00%  |       |
| State of Wisconsin (to total assets)                   |                    |        |                               |       |  |       |        |       |
| WaterStone Bank  | 356,075            | 20.45% | 104,462                       | 6.00% | N/   | A     | N/     | A     |
| December 31, 2014                                      |                    |        |                               |       |  |       |        |       |
| (Dollars In Thousands)                                 |                    |        |                               |       |  |       |        |       |
| Total capital (to risk-weighted assets)                | \$357,514          | 31.98% | 89,428                        | 8.00% | 111,785  |       | 10.00% |       |
| Tier I capital (to risk-weighted assets)               | 343,483            | 30.73% | 44,714                        | 4.00% | 67,071   |       | 6.00%  |       |
| Tier I capital (to average assets)                     | 343,483            | 19.04% | 72,175                        | 4.00% | 90,219   |       | 5.00%  |       |
| State of Wisconsin (to total assets)                   | 343,483            | 19.33% | 106,643                       | 6.00% | N/   | A     | N/     | A     |

Note 9 - Stock Based Compensation

Stock-Based Compensation Plan

In 2015, the Company's shareholders approved the 2015 Equity Incentive Plan. A total of 2,530,000 stock options and 1,012,000 restricted shares were approved for award.

Accounting for Stock-Based Compensation Plan

The fair value of stock options granted is estimated on the grant date using a Black-Scholes pricing model. The fair value of restricted shares is equal to the quoted NASDAQ market close price on the date of grant. The fair value of stock grants is recognized as compensation expense on a straight-line basis over the vesting period of the grants. Compensation expense is included in compensation, payroll taxes and other employee benefits in the

consolidated statements of income.

Assumptions are used in estimating the fair value of stock options granted. The weighted average expected life of the stock options represent the period of time that the options are expected to be outstanding and is based on the historical results from the previous awards. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected volatility is based on the actual volatility of a peer group including Waterstone Financial, Inc. stock from approximately five years prior to issuance date. The following assumptions were used in estimating the fair value of options granted in the year ending 2015.

|   | 2015    |         |
|---|---------|---------|
|   | Minimum | Maximum |
| Dividend yield                              | 1.51 %  | 1.57 %  |
| Risk-free interest rate                     | 1.60 %  | 1.72 %  |
| Expected volatility                         | 29.23 % | 31.88 % |
| Weighted average expected life (in years)   | 4.6     | 5.0     |
| Weighted average per share value of options | \$3.08  | 3.24    |

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The Company estimates potential forfeitures of stock grants and adjusts compensation expense recorded accordingly. The forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

The 590,000 stock options granted to employees under this plan vest over a period of five years. The 600,000 stock option awards granted to directors under this plan vest over a period of eight years. The exercise price for all stock options granted is equal to the quoted NASDAQ market close price on the date that the awards were granted and expire ten years after the grant date, if not exercised. The unrecognized expense related to these awards is \$3.5 million over the next eight years.

The 355,500 restricted stock awards granted to employees under this plan vest in five installments over four years with one installment vesting immediately. The 184,000 stock awards granted to directors under this plan vest in eight installments over seven years with one installment vesting immediately. The fair value of the awards was \$12.75 per award. The value of restricted stock awards is equal to the quoted NASDAQ market close price on the vest date. The unrecognized expense related to this award is \$5.0 million over the next seven years.

#### Note 10 – Income Taxes

Income tax expense increased from \$5.9 million during the nine months ended September 30, 2014 to \$7.7 million for the nine months ended September 30, 2015. This increase was due to the increase in our income before income taxes, which increased from \$16.3 million during the nine months ended September 30, 2014 to \$21.1 million during the nine months ended September 30, 2015. Income tax expense is recognized on the statement of income during the nine months ended September 30, 2015 at an effective rate of 36.2% of pretax income compared to 36.0% during the nine months ended September 30, 2014.

#### Note 11 – Offsetting of Assets and Liabilities

The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. In addition, the Company enters into agreements under which it sells loans held for sale subject to an obligation to repurchase the same loans. Under these arrangements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of assets. The obligation to repurchase the assets is reflected as a liability in the Company's consolidated statements of condition, while the securities and loans held for sale underlying the repurchase agreements remain in the respective investment securities and loans held for sale asset accounts. In other words, there is no offsetting or netting of the investment securities or loans held for sale assets with the repurchase agreement liabilities. One of the Company's two short-term repurchase agreements and all of the Company's long-term repurchase agreements are subject to master netting agreements, which sets forth the rights and obligations for repurchase and offset. Under the master netting agreement, the Company is entitled to set off the collateral placed with a single counterparty against obligations owed to that counterparty.

The following table presents the liabilities subject to an enforceable master netting agreement as of September 30, 2015 and December 31, 2014.

| Gross<br>Recognize<br>Liabilities | Gross<br>Amounts<br>Offset | Net<br>Amounts<br>Presented | Gross<br>Amounts<br>Not | Net<br>Amount |
|-----------------------------------|----------------------------|-----------------------------|-------------------------|---------------|
|-----------------------------------|----------------------------|-----------------------------|-------------------------|---------------|



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|                       | (In Thousands) |   |        | Offset |   |
|-----------------------|----------------|---|--------|--------|---|
| September 30, 2015    |                |   |        |        |   |
| Repurchase Agreements |                |   |        |        |   |
| Short-term            | \$-            | - | -      | -      | - |
| Long-term             | 84,000         | - | 84,000 | 84,000 | - |
|                       | \$84,000       | - | 84,000 | 84,000 | - |
| December 31, 2014     |                |   |        |        |   |
| Repurchase Agreements |                |   |        |        |   |
| Short-term            | \$-            | - | -      | -      | - |
| Long-term             | 84,000         | - | 84,000 | 84,000 | - |
|                       | \$84,000       | - | 84,000 | 84,000 | - |

## Note 12– Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

|   | September<br>30,<br>2015 | December<br>31, 2014 |
|---|--------------------------|----------------------|
|   | (In Thousands)           |                      |
| Financial instruments whose contract amounts represent potential credit risk: |                          |                      |
| Commitments to extend credit under amortizing loans (1)                       | \$34,651                 | 18,889               |
| Commitments to extend credit under home equity lines of credit                | 14,509                   | 14,775               |
| Unused portion of construction loans  | 25,839                   | 12,333               |
| Unused portion of business lines of credit                                    | 10,149                   | 11,599               |
| Standby letters of credit   | 609                      | 766                  |

(1) Excludes commitments to originate loans held for sale, which are discussed in the following footnote.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements of the Company. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral obtained generally consists of mortgages on the underlying real estate.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds mortgages on the underlying real estate as collateral supporting those commitments for which collateral is deemed necessary.

The amount of losses related to commitments to extend credit or the standby letters of credit were not significant as of September 30, 2015. The Company has determined that there are no probable losses related to commitments to extend credit or the standby letters of credit as of December 31, 2014.

## Note 13 – Derivative Financial Instruments

In connection with its mortgage banking activities, the Company enters into derivative financial instruments as part of its strategy to manage its exposure to changes in interest rates. Mortgage banking derivatives include interest rate lock commitments provided to customers to fund mortgage loans to be sold in the secondary market and forward commitments for the future delivery of such loans to third party investors. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of future changes in interest rates on its commitments to fund the loans as well as on its portfolio of mortgage loans held for sale. The Company's mortgage banking derivatives

have not been designated as hedge relationships. These instruments are used to manage the Company's exposure to interest rate movements and other identified risks but do not meet the strict hedge accounting requirements of ASC 815. Changes in the fair value of derivatives not designated in hedging relationships are recorded as a component of mortgage banking income in the Company's consolidated statements of operations. The Company does not use derivatives for speculative purposes.

Forward commitments to sell mortgage loans represent commitments obtained by the Company from a secondary market agency to purchase mortgages from the Company at specified interest rates and within specified periods of time. Commitments to sell loans are made to mitigate interest rate risk on interest rate lock commitments to originate loans and loans held for sale. At September 30, 2015, the Company had forward commitments to sell mortgage loans with an aggregate notional amount of approximately \$286.2 million and interest rate lock commitments with an aggregate notional amount of approximately \$192.0 million. The fair value of the forward commitments to sell mortgage loans at September 30, 2015 included a loss of \$1.5 million that is reported as a component of other liabilities on the Company's consolidated statement of financial condition. The fair value of the interest rate locks at September 30, 2015 included a gain of \$3.3 million that is reported as a component of other assets on the Company's consolidated statements of financial condition.

In determining the fair value of its derivative loan commitments, the Company considers the value that would be generated by the loan arising from exercise of the loan commitment when sold in the secondary mortgage market. That value includes the price that the loan is expected to be sold for in the secondary mortgage market. The fair value of these commitments is recorded on the consolidated statements of financial condition with the changes in fair value recorded as a component of mortgage banking income.

Residential mortgage loans sold to others are predominantly conventional residential first lien mortgages. The Company's agreements to sell residential mortgage loans in the normal course of business usually require certain representations and warranties on the underlying loans sold related to credit information, loan documentation and collateral, which if subsequently are untrue or breached, could require the Company to repurchase certain loans affected. The Company has only been required to make insignificant repurchases as a result of its representations and warranties. The Company's agreements to sell residential mortgage loans also contain limited recourse provisions. The recourse provisions are limited in that the recourse provision ends after certain payment criteria have been met. With respect to these loans, repurchase could be required if defined delinquency issues arose during the limited recourse period. Given that the underlying loans delivered to buyers are predominantly conventional first lien mortgages and that historical experience shows negligible losses and insignificant repurchase activity, management believes that losses and repurchases under the limited recourse provisions will continue to be insignificant.

## Note 14 – Earnings Per Share

Earnings per share are computed using the two-class method. Basic earnings per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted stock awards. Unvested restricted stock awards issued in 2012 are considered participating securities because holders of these securities have the right to receive dividends at the same rate as holders of the Company's common stock. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding adjusted for the dilutive effect of all potential common shares.

Presented below are the calculations for basic and diluted earnings per share:

|  | Three months<br>ended September<br>30,   |        | Nine months<br>ended September<br>30, |        |
|--|--|--------|---------------------------------------|--------|
|  | 2015                                     | 2014   | 2015                                  | 2014   |
|  | (In Thousands, except per share amounts) |        |                                       |        |
| Net income   | \$5,199                                  | 4,765  | 13,498                                | 10,418 |
| Net income available to unvested restricted shares | 6  | 7      | 15                                    | 15     |
| Net income available to common stockholders        | \$5,193                                  | 4,758  | 13,483                                | 10,403 |
| Weighted average shares outstanding                | 27,490                                   | 33,003 | 29,882                                | 33,759 |
| Effect of dilutive potential common shares         | 305                                      | 229    | 263                                   | 238    |
| Diluted weighted average shares outstanding        | 27,795                                   | 33,232 | 30,145                                | 33,997 |
| Basic earnings per share                           | \$0.19                                   | 0.14   | 0.45                                  | 0.31   |
| Diluted earnings per share                         | \$0.19                                   | 0.14   | 0.45                                  | 0.31   |

## Note 15 – Fair Value Measurements

The FASB issued an accounting standard (subsequently codified into ASC Topic 820, "Fair Value Measurements and Disclosures") which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This accounting standard applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements. The standard also emphasizes that fair value (i.e., the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date), among other things, is based on exit price versus entry price, should include assumptions about risk such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. When considering the assumptions that market participants would use in pricing the asset or liability, this accounting standard establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

The fair value hierarchy prioritizes inputs used to measure fair value into three broad levels.

Level 1 inputs - In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that we have the ability to access.

Level 2 inputs - Fair values determined by Level 2 inputs use inputs other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets where there are few transactions and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

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Level 3 inputs - Level 3 inputs are unobservable inputs for the asset or liability and include situations where there is little, if any, market activity for the asset or liability.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The following table presents information about our assets recorded in our consolidated statement of financial position at their fair value on a recurring basis as of September 30, 2015 and December 31, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

|   | Fair Value Measurements |               |         |         |
|---|-------------------------|---------------|---------|---------|
|   | September 30, 2015      | Using Level 1 | Level 2 | Level 3 |
|   | (In Thousands)          |               |         |         |
| Available for sale securities           |                         |               |         |         |
| Mortgage-backed securities              | \$ 103,574              | -             | 103,574 | -       |
| Collateralized mortgage obligations     |                         |               |         |         |
| Government sponsored enterprise issued  | 56,556                  | -             | 56,556  | -       |
| Government sponsored enterprise bonds   | 3,765                   | -             | 3,765   | -       |
| Municipal securities                    | 73,090                  | -             | 73,090  | -       |
| Other debt securities                   | 17,114                  | 2,568         | 14,546  | -       |
| Certificates of deposit                 | 3,437                   | -             | 3,437   | -       |
| Loans held for sale                     | 141,808                 | -             | 141,808 | -       |
| Mortgage banking derivative assets      | 3,304                   | -             | -       | 3,304   |
| Mortgage banking derivative liabilities | 1,465                   | -             | -       | 1,465   |

|   | Fair Value Measurements |               |         |         |
|---|-------------------------|---------------|---------|---------|
|   | December 31, 2014       | Using Level 1 | Level 2 | Level 3 |
|   | (In Thousands)          |               |         |         |
| Available for sale securities           |                         |               |         |         |
| Mortgage-backed securities              | \$ 117,128              | -             | 117,128 | -       |
| Collateralized mortgage obligations     |                         |               |         |         |
| Government sponsored enterprise issued  | 59,071                  | -             | 59,071  | -       |
| Government sponsored enterprise bonds   | 6,711                   | -             | 6,711   | -       |
| Municipal securities                    | 77,108                  | -             | 77,108  | -       |
| Other debt securities                   | 7,528                   | 2,550         | 4,978   | -       |
| Certificates of deposit                 | 5,897                   | -             | 5,897   | -       |
| Loans held for sale                     | 125,073                 | -             | 125,073 | -       |
| Mortgage banking derivative assets      | 1,644                   | -             | -       | 1,644   |
| Mortgage banking derivative liabilities | 645                     | -             | -       | 645     |

The following summarizes the valuation techniques for assets recorded in our consolidated statements of financial condition at their fair value on a recurring basis:

Available for sale securities – The Company's investment securities classified as available for sale include: mortgage-backed securities, collateralized mortgage obligations, government sponsored enterprise bonds, municipal securities and other debt securities. The fair value of mortgage-backed securities, collateralized mortgage obligations and government sponsored enterprise bonds are determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities, prepayment models and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. These model and matrix measurements are classified as Level 2 in the fair value hierarchy. The fair value of municipal securities is determined by a third party valuation source using observable market data utilizing a multi-dimensional relational pricing model. Standard inputs to this model include observable market data such as benchmark yields, reported trades, broker quotes, rating updates and issuer spreads. These model measurements are classified as Level 2 in the fair value hierarchy. The fair value of other debt securities, which includes a trust preferred security issued by a financial institution, is determined through quoted prices in active markets and is classified as Level 1 in the fair value hierarchy.

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Loans held for sale – The Company carries loans held for sale at fair value under the fair value option model. Fair value is generally determined by estimating a gross premium or discount, which is derived from pricing currently observable in the secondary market, principally from observable prices for forward sale commitments. Loans held-for-sale are considered to be Level 2 in the fair value hierarchy of valuation techniques.

Mortgage banking derivatives - Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company relies on a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment and then multiplying by quoted investor prices. The Company also relies on a valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. While there are Level 2 and 3 inputs used in the valuation models, the Company has determined that one or more of the inputs significant in the valuation of both of the mortgage banking derivatives fall within Level 3 of the fair value hierarchy.

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2015 and 2014.

|                               | Mortgage<br>banking<br>derivatives,<br>net<br>(In<br>Thousands) |
|-------------------------------|---|
| Balance at December 31, 2013  | \$ 1,189  |
| Mortgage derivative loss, net | (190 )  |
| Balance at December 31, 2014  | \$ 999  |
| Mortgage derivative gain, net | 840   |
| Balance at September 30, 2015 | \$ 1,839  |

There were no transfers in or out of Level 1, 2 or 3 measurements during the periods.  
Assets Recorded at Fair Value on a Non-recurring Basis

The following table presents information about our assets recorded in our consolidated statement of financial position at their fair value on a non-recurring basis as of September 30, 2015 and December 31, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

|                         | Fair Value<br>Measurements<br>Using |            |            |            |
|-------------------------|-------------------------------------|------------|------------|------------|
|                         | September<br>30,<br>2015            | Level<br>1 | Level<br>2 | Level<br>3 |
|                         | (In Thousands)                      |            |            |            |
| Impaired loans, net (1) | \$7,388                             | -          | -          | 7,388      |
| Real estate owned       | 12,156                              | -          | -          | 12,156     |



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|                                    |                         |            |            |                                     |
|------------------------------------|-------------------------|------------|------------|-------------------------------------|
| Impaired mortgage servicing rights | 38                      | -          | -          | 38                                  |
|                                    |                         |            |            | Fair Value<br>Measurements<br>Using |
|                                    | December<br>31,<br>2014 | Level<br>1 | Level<br>2 | Level<br>3                          |
|                                    | (In Thousands)          |            |            |                                     |
| Impaired loans, net (1)            | \$18,758                | -          | -          | 18,758                              |
| Real estate owned                  | 18,706                  | -          | -          | 18,706                              |
| Impaired mortgage servicing rights | 9                       | -          | -          | 9                                   |

(1) Represents collateral-dependent impaired loans, net, which are included in loans.

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Loans – We do not record loans at fair value on a recurring basis. On a non-recurring basis, loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on our consolidated statements of financial condition at net realizable value of the underlying collateral. Fair value is determined based on third party appraisals. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of impaired loans, loans that have been deemed to be impaired are considered to be Level 3 in the fair value hierarchy of valuation techniques. At September 30, 2015, loans determined to be impaired with an outstanding balance of \$9.5 million were carried net of specific reserves of \$2.1 million for a fair value of \$7.4 million. At December 31, 2014, loans determined to be impaired with an outstanding balance of \$22.5 million were carried net of specific reserves of \$3.7 million for a fair value of \$18.8 million. Impaired loans collateralized by assets which are valued in excess of the net investment in the loan do not require any specific reserves.

Real estate owned – On a non-recurring basis, real estate owned, is recorded in our consolidated statements of financial condition at the lower of cost or fair value. Fair value is determined based on third party appraisals and, if less than the carrying value of the foreclosed loan, the carrying value of the real estate owned is adjusted to the fair value. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. Given the significance of the adjustments made to appraised values necessary to estimate the fair value of the properties, real estate owned is considered to be Level 3 in the fair value hierarchy of valuation techniques. Changes in the value of real estate owned totaled \$1.5 million and \$1.0 million during the nine months ended September 30, 2015 and 2014, respectively and are recorded in real estate owned expense. At September 30, 2015 and December 31, 2014, real estate owned totaled \$12.2 million and \$18.7 million, respectively.

Mortgage servicing rights - The Company utilizes an independent valuation from a third party which uses a discounted cash flow model to estimate the fair value of mortgage servicing rights. The model utilizes prepayment assumptions to project cash flows related to the mortgage servicing rights based upon the current interest rate environment, which is then discounted to estimate an expected fair value of the mortgage servicing rights. The model considers characteristics specific to the underlying mortgage portfolio, such as: contractually specified servicing fees, prepayment assumptions, delinquency rates, late charges and costs to service. Given the significance of the unobservable inputs utilized in the estimation process, mortgage servicing rights are classified as Level 3 within the fair value hierarchy. The Company records the mortgage servicing rights at the lower of amortized cost or fair value. At September 30, 2015 and December 31, 2014, the company determined that \$38,000 and \$9,000, respectively of mortgage servicing rights were partially impaired, and as a result, recorded an impairment valuation allowance of \$20,000 and \$10,000, respectively.

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of September 30, 2015, the significant unobservable inputs used in the fair value measurements were as follows:

|                              | Fair Value at September 30, 2015 | Valuation Technique | Significant Unobservable Inputs      | Significant Unobservable Input Value |               |
|------------------------------|----------------------------------|---------------------|--------------------------------------|--------------------------------------|---------------|
|                              |                                  |                     |                                      | Minimum Value                        | Maximum Value |
| Mortgage banking derivatives | \$ 1,839                         | Pricing models      | Pull through rate                    | 56.2 %                               | 99.9 %        |
| Impaired loans               | 7,388                            | Market approach     | Discount rates applied to appraisals | 15.0 %                               | 30.0 %        |
| Real estate owned            | 12,156                           |                     |                                      | 5.0 %                                | 89.4 %        |

|                                    |    | Market approach | Discount rates applied to appraisals |         |           |  |
|------------------------------------|----|-----------------|--------------------------------------|---------|-----------|--|
| Impaired mortgage servicing rights | 38 | Pricing models  | Prepayment rate                      | 7.8 %   | 27.5 %    |  |
|                                    |    |                 | Discount rate                        | 10.0 %  | 11.0 %    |  |
|                                    |    |                 | Cost to service                      | \$76.37 | \$ 321.60 |  |

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One of the significant unobservable inputs used in the fair value measurement of the Company's mortgage banking derivatives, including interest rate lock commitments is the loan pull through rate. This represents the percentage of loans currently in a lock position which the Company estimates will ultimately close. The pull through rate is largely dependent on the loan processing stage that a loan is currently in and the change in prevailing interest rates from the time of the rate lock. The pull through rate is computed using historical data and the ratio is periodically reviewed by the Company.

The significant unobservable inputs used in the fair value measurement of collateral for collateral-dependent impaired loans and real estate owned included in the above table primarily relate to discounting criteria applied to independent appraisals received with respect to the collateral. Discounts applied to the appraisals are dependent on the vintage of the appraisal as well as the marketability of the property. The discount factor is computed using actual realization rates on properties that have been foreclosed upon and liquidated in the open market.

The significant unobservable inputs used in the fair value measurement of mortgage servicing rights include the prepayment rate, note rate, and cost to service. The prepayment rate represents the assumed rate of prepayment of the outstanding principal balance of the underlying mortgage notes. Generally, the fair value of mortgage servicing rights will be positively impacted as prepayment rate decreases and negatively impacted when the prepayment rate increases. The note rate represents the contractual rate on the underlying mortgages.

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Fair value information about financial instruments follows, whether or not recognized in the consolidated statements of financial condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and fair values of the Company's financial instruments consist of the following:

|   | September 30, 2015 |                  |         |         |           | December 31, 2014 |                  |         |         |           |
|---|--------------------|------------------|---------|---------|-----------|-------------------|------------------|---------|---------|-----------|
|   | Carrying amount    | Fair Value Total | Level 1 | Level 2 | Level 3   | Carrying amount   | Fair Value Total | Level 1 | Level 2 | Level 3   |
| <b>Financial Assets</b>                 |                    |                  |         |         |           |                   |                  |         |         |           |
| Cash and cash equivalents               | \$ 130,400         | 130,400          | 118,150 | 12,250  | -         | 172,820           | 172,820          | 167,370 | 5,450   | -         |
| Securities available-for-sale           | 257,536            | 257,536          | 2,568   | 254,968 | -         | 273,443           | 273,443          | 2,550   | 270,893 | -         |
| Loans held for sale                     | 141,808            | 141,808          | -       | 141,808 | -         | 125,073           | 125,073          | -       | 125,073 | -         |
| Loans receivable                        | 1,100,641          | 1,156,820        | -       | -       | 1,156,820 | 1,094,990         | 1,184,398        | -       | -       | 1,184,398 |
| HLB stock                               | 19,500             | 19,500           | -       | 19,500  | -         | 17,500            | 17,500           | -       | 17,500  | -         |
| Accrued interest receivable             | 4,247              | 4,247            | 4,247   | -       | -         | 4,029             | 4,029            | 4,029   | -       | -         |
| Mortgage servicing rights               | 978                | 1,062            | -       | -       | 1,062     | 2,511             | 2,808            | -       | -       | 2,808     |
| Mortgage banking derivative assets      | 3,304              | 3,304            | -       | -       | 3,304     | 1,644             | 1,644            | -       | -       | 1,644     |
| <b>Financial Liabilities</b>            |                    |                  |         |         |           |                   |                  |         |         |           |
| Deposits in advance                     | 873,155            | 873,397          | 232,830 | 640,567 | -         | 863,960           | 866,173          | 211,325 | 654,848 | -         |
| Payments by borrowers for taxes         | 23,839             | 23,839           | 23,839  | -       | -         | 4,991             | 4,991            | 4,991   | -       | -         |
| Borrowings                              | 434,000            | 461,460          | -       | 461,460 | -         | 434,000           | 459,484          | -       | 459,484 | -         |
| Accrued interest payable                | 1,566              | 1,566            | 1,566   | -       | -         | 1,600             | 1,600            | 1,600   | -       | -         |
| Mortgage banking derivative liabilities | 1,465              | 1,465            | -       | -       | 1,465     | 645               | 645              | -       | -       | 645       |

The following methods and assumptions were used by the Company in determining its fair value disclosures for financial instruments.

### Cash and Cash Equivalents

The carrying amount reported in the consolidated statements of financial condition for cash and cash equivalents is a reasonable estimate of fair value.

### Securities

The fair value of securities is generally determined by a third party valuation source using observable market data utilizing a matrix or multi-dimensional relational pricing model. Standard inputs to these models include observable market data such as benchmark yields, reported trades, broker quotes, issuer spreads, benchmark securities and bid/offer market data. For securities with an early redemption feature, an option adjusted spread model is utilized to adjust the issuer spread. Prepayment models are used for mortgage related securities with prepayment features.

### Loans Held for Sale

Fair value is estimated using the prices of the Company's existing commitments to sell such loans and/or the quoted market price for commitments to sell similar loans.

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### Loans Receivable

Loans determined to be impaired are analyzed to determine whether a collateral shortfall exists, and if such a shortfall exists, are recorded on our consolidated statements of financial condition at fair value. Fair value is determined based on third party appraisals. Appraised values are adjusted to consider disposition costs and also to take into consideration the age of the most recent appraisal. With respect to loans that are not considered to be impaired, fair value is estimated by discounting the future contractual cash flows using discount rates that reflect a current rate offered to borrowers of similar credit standing for the remaining term to maturity. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820-10 and generally produces a higher fair value.

### FHLB Stock

For FHLB stock, the carrying amount is the amount at which shares can be redeemed with the FHLB and is a reasonable estimate of fair value.

### Deposits and Advance Payments by Borrowers for Taxes

The fair values for interest-bearing and noninterest-bearing negotiable order of withdrawal accounts, savings accounts, and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates of similar remaining maturities to a schedule of aggregated expected monthly maturities of the outstanding certificates of deposit. The advance payments by borrowers for taxes are equal to their carrying amounts at the reporting date.

### Borrowings

Fair values for borrowings are estimated using a discounted cash flow calculation that applies current interest rates to estimated future cash flows of the borrowings.

### Accrued Interest Payable and Accrued Interest Receivable

For accrued interest payable and accrued interest receivable, the carrying amount is a reasonable estimate of fair value.

### Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would be generally established at market rates at the time of the draw. Fair values for the Company's commitments to extend credit and standby letters of credit are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the counterparty's credit standing, and discounted cash flow analyses. The fair value of the Company's commitments to extend credit is not material at September 30, 2015 and December 31, 2014.

### Mortgage Banking Derivative Assets and Liabilities

Mortgage banking derivatives include interest rate lock commitments to originate residential loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. The Company relies on a valuation model to estimate the fair value of its interest rate lock commitments to originate residential mortgage loans held for sale, which includes applying a pull through rate based upon historical experience and the current interest rate environment, and then multiplying by quoted investor prices. The Company also relies on a

valuation model to estimate the fair value of its forward commitments to sell residential loans, which includes matching specific terms and maturities of the forward commitments against applicable investor pricing available. On the Company's Consolidated Statements of Condition, instruments that have a positive fair value are included in prepaid expenses and other assets, and those instruments that have a negative fair value are included in other liabilities.

## Note 16 – Segment Reporting

Selected financial and descriptive information is required to be provided about reportable operating segments, considering a "management approach" concept as the basis for identifying reportable segments. The management approach is based on the way that management organizes the segments within the enterprise for making operating decisions, allocating resources, and assessing performance. Consequently, the segments are evident from the structure of the enterprise's internal organization, focusing on financial information that an enterprise's chief operating decision-makers use to make decisions about the enterprise's operating matters. The Company has determined that it has two reportable segments: community banking and mortgage banking. The Company's operating segments are presented based on its management structure and management accounting practices. The structure and practices are specific to the Company and therefore, the financial results of the Company's business segments are not necessarily comparable with similar information for other financial institutions.

## Community Banking

The Community Banking segment provides consumer and business banking products and services to customers primarily within Southeastern Wisconsin along with a loan production office in Minneapolis, Minnesota. Within this segment, the following products and services are provided: (1) lending solutions such as residential mortgages, home equity loans and lines of credit, personal and installment loans, real estate financing, business loans, and business lines of credit; (2) deposit and transactional solutions such as checking, credit, debit and pre-paid cards, online banking and bill pay, and money transfer services; (3) investable funds solutions such as savings, money market deposit accounts, IRA accounts, certificates of deposit, and (4) fixed and variable annuities, insurance as well as trust and investment management accounts.

Consumer products include loan and deposit products: mortgage, home equity loans and lines, personal term loans, demand deposit accounts, interest bearing transaction accounts and time deposits. Consumer products also include personal investment services. Business banking products include secured and unsecured lines and term loans for working capital, inventory and general corporate use, commercial real estate construction loans, demand deposit accounts, interest bearing transaction accounts and time deposits.

## Mortgage Banking

The Mortgage Banking segment provides residential mortgage loans for the primary purpose of sale on the secondary market. Mortgage banking products and services are provided by offices in 18 states.

|   | As of or for the three months ended September 30, 2015 |                  |                           |              |
|---|--|------------------|---------------------------|--------------|
|   | Community Banking                                      | Mortgage Banking | Holding Company and Other | Consolidated |
|   | (In Thousands)   |                  |                           |              |
| Net interest income                                 | \$9,566  | 265              | 79                        | 9,910        |
| Provision for loan losses                           | 500  | 80               | -                         | 580          |
| Net interest income after provision for loan losses | 9,066  | 185              | 79                        | 9,330        |
| Noninterest income                                  | 1,146  | 27,636           | (231 )                    | 28,551       |



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Noninterest expenses:

|  |             |         |          |   |           |
|--|-------------|---------|----------|---|-----------|
| Compensation, payroll taxes, and other employee benefits | 3,927       | 17,411  | (104     | ) | 21,234    |
| Occupancy, office furniture and equipment                | 800         | 1,492   | -        |   | 2,292     |
| FDIC insurance premiums                                  | 243         | -       | -        |   | 243       |
| Real estate owned  | 646         | -       | -        |   | 646       |
| Other  | 1,171       | 4,235   | (35      | ) | 5,371     |
| Total noninterest expenses                               | 6,787       | 23,138  | (139     | ) | 29,786    |
| Income before income taxes                               | 3,425       | 4,683   | (13      | ) | 8,095     |
| Income tax expense                                       | 962         | 1,917   | 17       |   | 2,896     |
| Net income   | \$2,463     | 2,766   | (30      | ) | 5,199     |
| <br>   |             |         |          |   |           |
| Total assets   | \$1,724,714 | 176,341 | (156,346 | ) | 1,744,709 |

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|  | As of or for the three months ended September 30,<br>2014 |                     |                                    |              |
|--|---|---------------------|------------------------------------|--------------|
|  | Community<br>Banking                                      | Mortgage<br>Banking | Holding<br>Company<br>and<br>Other | Consolidated |
|  | (In Thousands)  |                     |                                    |              |
| Net interest income                                      | \$10,501  | 232                 | 181                                | 10,914       |
| Provision for loan losses                                | 250   | 65                  | -                                  | 315          |
| Net interest income after provision for loan losses      | 10,251  | 167                 | 181                                | 10,599       |
| Noninterest income                                       | 1,047   | 22,990              | (126 )                             | 23,911       |
| Noninterest expenses:                                    |   |                     |                                    |              |
| Compensation, payroll taxes, and other employee benefits | 3,295   | 15,049              | (175 )                             | 18,169       |
| Occupancy, office furniture and equipment                | 771   | 1,806               | -                                  | 2,577        |
| FDIC insurance premiums                                  | 336   | -                   | -                                  | 336          |
| Real estate owned  | 665   | -                   | -                                  | 665          |
| Other  | 1,091   | 4,236               | (44 )                              | 5,283        |
| Total noninterest expenses                               | 6,158   | 21,091              | (219 )                             | 27,030       |
| Income before income taxes                               | 5,140   | 2,066               | 274                                | 7,480        |
| Income tax expense                                       | 1,734   | 834                 | 147                                | 2,715        |
| Net income   | \$3,406   | 1,232               | 127                                | 4,765        |
| Total assets   | \$1,767,878   | 166,658             | (135,211 )                         | 1,799,325    |

|  | As of or for the nine months ended September<br>30, 2015 |                     |                                    |              |
|--|--|---------------------|------------------------------------|--------------|
|  | Community<br>Banking                                     | Mortgage<br>Banking | Holding<br>Company<br>and<br>Other | Consolidated |
|  | (In Thousands)   |                     |                                    |              |
| Net interest income                                      | \$28,541   | 615                 | 250                                | 29,406       |
| Provision for loan losses                                | 1,450  | 270                 | -                                  | 1,720        |
| Net interest income after provision for loan losses      | 27,091   | 345                 | 250                                | 27,686       |
| Noninterest income                                       | 2,824  | 79,193              | (393 )                             | 81,624       |
| Noninterest expenses:                                    |  |                     |                                    |              |
| Compensation, payroll taxes, and other employee benefits | 12,462   | 50,438              | (316 )                             | 62,584       |
| Occupancy, office furniture and equipment                | 2,447  | 4,557               | -                                  | 7,004        |
| FDIC insurance premiums                                  | 851  | -                   | -                                  | 851          |
| Real estate owned  | 1,860  | 15                  | -                                  | 1,875        |
| Other  | 3,275  | 12,434              | 138                                | 15,847       |
| Total noninterest expenses                               | 20,895   | 67,444              | (178 )                             | 88,161       |
| Income before income taxes                               | 9,020  | 12,094              | 35                                 | 21,149       |
| Income tax expense                                       | 2,544  | 5,018               | 89                                 | 7,651        |

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|            |         |       |     |   |        |
|------------|---------|-------|-----|---|--------|
| Net income | \$6,476 | 7,076 | (54 | ) | 13,498 |
|------------|---------|-------|-----|---|--------|

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As of or for the nine months ended September 30, 2014

|  | Community<br>Banking | Mortgage<br>Banking | Holding<br>Company<br>and<br>Other | Consolidated |
|--|----------------------|---------------------|------------------------------------|--------------|
|  | (In Thousands)       |                     |                                    |              |
| Net interest income                                      | \$29,947             | 756                 | 521                                | 31,224       |
| Provision for loan losses                                | 750                  | 100                 | -                                  | 850          |
| Net interest income after provision for loan losses      | 29,197               | 656                 | 521                                | 30,374       |
| Noninterest income                                       | 2,324                | 62,125              | (284 )                             | 64,165       |
| Noninterest expenses:                                    |                      |                     |                                    |              |
| Compensation, payroll taxes, and other employee benefits | 10,430               | 41,175              | (187 )                             | 51,418       |
| Occupancy, office furniture and equipment                | 2,477                | 5,406               | -                                  | 7,883        |
| FDIC insurance premiums                                  | 1,046                | -                   | -                                  | 1,046        |
| Real estate owned  | 1,918                | -                   | -                                  | 1,918        |
| Other  | 3,565                | 12,416              | 18                                 | 15,999       |
| Total noninterest expenses                               | 19,436               | 58,997              | (169 )                             | 78,264       |
| Income before income taxes                               | 12,085               | 3,784               | 406                                | 16,275       |
| Income tax expense                                       | 4,102                | 1,526               | 229                                | 5,857        |
| Net income   | \$7,983              | 2,258               | 177                                | 10,418       |

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

Forward-Looking Information

This Form 10-Q contains or incorporates by reference various forward-looking statements, which can be identified by the use of words such as "estimate," "project," "believe," "intend," "anticipate," "plan," "seek," "expect" and similar expressions and verbs in the future tense, are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to:

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

These forward-looking statements are based on current beliefs and expectations of our management and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins and yields, our mortgage banking revenues, the fair value of financial instruments or the origination levels in our lending business, or increase the level of defaults, losses or prepayments on loans we have made and make whether held in portfolio or sold in the secondary markets;
- adverse changes in the securities or secondary mortgage markets;
- changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;
- our ability to manage market risk, credit risk and operational risk in the current economic conditions;
- our ability to enter new markets successfully and capitalize on growth opportunities;
- our ability to successfully integrate acquired entities;
- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission or the Public Company Accounting Oversight Board;
- our ability to retain key employees;
- significant increases in our loan losses; and
- changes in the financial condition, results of operations or future prospects of issuers of securities that we own.

See also the factors referred to in reports filed by the Company with the Securities and Exchange Commission (particularly those under the caption "Risk Factors" in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2014).

## Overview

The following discussion and analysis is presented to assist the reader in understanding and evaluating of the Company's financial condition and results of operations. It is intended to complement the unaudited consolidated financial statements, footnotes, and supplemental financial data appearing elsewhere in this Form 10-Q and should be read in conjunction therewith. The detailed discussion in the sections below focuses on the results of operations for the three and nine months ended September 30, 2015 and 2014 and the financial condition as of September 30, 2015 compared to the financial condition as of December 31, 2014.

As described in the notes to consolidated financial statements, we have two reportable segments: community banking and mortgage banking. The community banking segment provides consumer and business banking products and services to customers. Consumer products include loan products, deposit products, and personal investment services. Business banking products include loans for working capital, inventory and general corporate use, commercial real estate construction loans, and deposit accounts. The mortgage banking segment, which is conducted through Waterstone Mortgage Corporation, consists of originating residential mortgage loans primarily for sale in the secondary market.

Our community banking segment generates the significant majority of our consolidated net interest income and requires the significant majority of our provision for loan losses. Our mortgage banking segment generates the significant majority of our noninterest income and a majority of our noninterest expenses. We have provided below a discussion of the material results of operations for each segment on a separate basis for the three and nine months ended September 30, 2015 and 2014, which focuses on noninterest income and noninterest expenses. We have also provided a discussion of the consolidated operations of Waterstone Financial, which includes the consolidated operations of WaterStone Bank and Waterstone Mortgage Corporation, for the same periods.

### Comparison of Community Banking Segment for the Three Months Ended September 30, 2015 and 2014

Net income for the three months ended September 30, 2015 totaled \$2.5 million compared to net income of \$3.4 million for the three months ended September 30, 2014. Net interest income decreased \$935,000 to \$9.6 million for the three months ended September 30, 2015 compared to \$10.5 million the three months ended September 30, 2014. The provision for loan losses increased \$250,000 compared to the prior year comparable period. Compensation, payroll taxes, and other employee benefits expense increased due to the distribution of additional equity awards in 2015 along with a slight increase in occupancy, office furniture, and equipment expense and other expense partially offset by a reduction in the FDIC insurance premium expense and a slight decrease in real estate owned expense for the three months ended September 30, 2015 compared to the three months ended September 30, 2014.

### Comparison of Mortgage Banking Segment Operations for the Three Months Ended September 30, 2015 and 2014

Net income totaled \$2.8 million for the three months ended September 30, 2015, compared to \$1.2 million during the three months ended September 30, 2014. Mortgage banking segment revenues increased \$4.6 million, or 20.2%, to \$27.6 million for the three months ended September 30, 2015 compared to \$23.0 million for the three months ended September 30, 2014. The increase in revenue was attributable to an increase in purchase volume and margin. While revenue increased 20.2%, noninterest expenses increased \$2.0 million, or 9.7%, to \$23.1 million for the three months ended September 30, 2015 compared to \$21.1 million for the three months ended September 30, 2014. The improvement in net income was due to ongoing expense control efforts.

## Consolidated Waterstone Financial, Inc. Results of Operations

|                                     | Three months<br>ended<br>September 30,<br>2015    2014<br>(Dollars in<br>Thousands,<br>except per share<br>amounts) |        |
|-------------------------------------|---|--------|
| Net income                          | \$5,199   | 4,765  |
| Earnings per share - basic          | 0.19  | 0.14   |
| Earnings per share - diluted        | 0.19  | 0.14   |
| Annualized return on average assets | 1.18 %  | 1.05 % |
| Annualized return on average equity | 5.21 %  | 4.23 % |

Net Interest Income

## Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans were included in the computation of the average balances of loans receivable and held for sale. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense. Yields on interest-earning assets are computed on a fully tax-equivalent yield, where applicable.

|   | Three months ended September 30, |          |            |               |          |            |   |
|---|----------------------------------|----------|------------|---------------|----------|------------|---|
|   | 2015                             |          |            | 2014          |          |            |   |
|   | Average                          | Interest | Yield/Cost | Average       | Interest | Yield/Cost |   |
|   | Balance                          |          |            | Balance       |          |            |   |
|   | (Dollars in Thousands)           |          |            |               |          |            |   |
| <b>Assets</b>   |                                  |          |            |               |          |            |   |
| Interest-earning assets:  |                                  |          |            |               |          |            |   |
| Loans receivable and held for sale (1)                                | \$1,243,879                      | 14,117   | 4.50       | % \$1,277,634 | 14,942   | 4.64       | % |
| Mortgage related securities (2)                                       | 165,839                          | 792      | 1.89       | % 183,356     | 835      | 1.81       | % |
| Debt securities, federal funds sold and short-term investments (2)(3) | 234,102                          | 1,115    | 1.89       | % 239,087     | 1,063    | 1.76       | % |
| Total interest-earning assets   | 1,643,820                        | 16,024   | 3.87       | % 1,700,077   | 16,840   | 3.93       | % |
| Noninterest-earning assets  | 98,224                           |          |            | 97,855        |          |            |   |
| Total assets  | \$1,742,044                      |          |            | \$1,797,932   |          |            |   |
| <b>Liabilities and equity</b>   |                                  |          |            |               |          |            |   |
| Interest-bearing liabilities:   |                                  |          |            |               |          |            |   |
| Demand accounts   | \$31,980                         | 5        | 0.06       | % \$43,352    | 4        | 0.04       | % |
| Money market and savings accounts                                     | 152,346                          | 59       | 0.15       | % 141,857     | 31       | 0.09       | % |
| Time deposits   | 641,064                          | 1,476    | 0.91       | % 651,608     | 1,302    | 0.79       | % |
| Total interest-bearing deposits                                       | 825,390                          | 1,540    | 0.74       | % 836,817     | 1,337    | 0.63       | % |
| Borrowings  | 434,943                          | 4,345    | 3.96       | % 438,644     | 4,349    | 3.93       | % |
| Total interest-bearing liabilities                                    | 1,260,333                        | 5,885    | 1.85       | % 1,275,461   | 5,686    | 1.77       | % |
| Noninterest-bearing liabilities                                       |                                  |          |            |               |          |            |   |
| Noninterest-bearing deposits  | 65,016                           |          |            | 48,697        |          |            |   |
| Other noninterest-bearing liabilities                                 | 21,099                           |          |            | 27,159        |          |            |   |
| Total noninterest-bearing liabilities                                 | 86,115                           |          |            | 75,856        |          |            |   |
| Total liabilities   | 1,346,448                        |          |            | 1,351,317     |          |            |   |
| Equity  | 395,596                          |          |            | 446,615       |          |            |   |
| Total liabilities and equity  | \$1,742,044                      |          |            | \$1,797,932   |          |            |   |
| Net interest income   |                                  | 10,139   |            |               | 11,154   |            |   |
| Net interest rate spread (4)  |                                  |          | 2.02       | %             |          | 2.16       | % |
| Less: taxable equivalent adjustment                                   |                                  | 229      |            |               | 240      |            |   |
| Net interest income, as reported                                      |                                  | 9,910    |            |               | 10,914   |            |   |
| Net interest-earning assets (5)                                       | \$383,487                        |          |            | \$424,616     |          |            |   |
| Net interest margin (6)   |                                  |          | 2.39       | %             |          | 2.55       | % |
| Tax equivalent effect   |                                  |          | 0.06       | %             |          | 0.05       | % |
| Net interest margin on a fully tax equivalent basis (6)               |                                  |          | 2.45       | %             |          | 2.60       | % |



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|   |          |          |
|---|----------|----------|
| Average interest-earning assets to average interest-bearing liabilities | 130.43 % | 133.29 % |
|---|----------|----------|

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(1) Interest income includes net deferred loan fee amortization income of \$139,000 and \$158,000 for the three months ended September 30, 2015 and 2014, respectively.

(2) Average balance of mortgage related and debt securities are based on amortized historical cost.

(3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 1.50% and 1.37% for the three months ended September 30, 2015 and 2014, respectively.

(4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis.

(5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.

(6) Net interest margin represents net interest income divided by average total interest-earning assets.

## Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

|   | Three months ended<br>September 30,<br>2015 versus 2014<br>Increase (Decrease)<br>due to |       |         |
|---|--|-------|---------|
|   | Volume   | Rate  | Net     |
|   | (In Thousands)   |       |         |
| Interest income:                          |  |       |         |
| Loans receivable and held for sale (1)(2) | \$(435)  | (390) | (825 )  |
| Mortgage related securities (3)           | (82 )  | 39    | (43 )   |
| Other earning assets (3) (4)              | (22 )  | 74    | 52      |
| Total interest-earning assets             | (539)  | (277) | (816 )  |
| Interest expense:                         |  |       |         |
| Demand accounts                           | (1 )   | 2     | 1       |
| Money market and savings accounts         | 2  | 26    | 28      |
| Time deposits                             | (21 )  | 195   | 174     |
| Total interest-earning deposits           | (20 )  | 223   | 203     |
| Borrowings                                | (37 )  | 33    | (4 )    |
| Total interest-bearing liabilities        | (57 )  | 256   | 199     |
| Net change in net interest income         | \$(482)  | (533) | (1,015) |

(1) Interest income includes net deferred loan fee amortization income of \$139,000 and \$158,000 for the three months ended September 30, 2015 and 2014, respectively.

(2) Non-accrual loans have been included in average loans receivable balance.

(3) Includes available for sale securities. Average balance of available for sale securities is based on amortized historical cost.

(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented.

Net interest income decreased \$1.0 million, or 9.2%, to \$9.9 million during the three months ended September 30, 2015 compared to \$10.9 million during the three months ended September 30, 2014.

Interest income on loans decreased due to a 14 basis point decrease in average yield on loans.

Interest income from mortgage-related securities decreased due to a decrease in the average balance of mortgage-related securities. Funds received from the second step offering completed in January 2014 were used to purchase additional securities throughout 2014. As securities have paid down in 2015, less purchases have occurred to replace those securities due to current market conditions.

Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) increased due to a 13 basis point increase in average yield on other earning assets. The increase relates to an increase in higher yielding debt securities in 2015 compared to cash being held in 2014.

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Interest expense on deposits increased primarily due to an increase in the average cost of time deposits of 12 basis points offset by a slightly lower average balance.

Interest expense on borrowings decreased slightly due to the decreased use of short-term repurchase agreements within our mortgage banking segment to fund loan originations to be sold in the secondary market during the three months ended September 30, 2015.

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Provision for Loan Losses

Our provision for loan losses increased \$265,000, or 84.1%, to \$580,000 during the three months ended September 30, 2015, from \$315,000 during the three months ended September 30, 2014. The increase was largely related to one loan collateralized by a multi-family property.

The provision is primarily a function of the Company's reserving methodology and assessments of certain quantitative and qualitative factors which are used to determine an appropriate allowance for loan losses for the period. See further discussion regarding the allowance for loan losses in the "Asset Quality" section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions and the "Allowance for Loan Loss" section.

Noninterest Income

|  | Three months ended September 30, |        |           |          |   |
|--|----------------------------------|--------|-----------|----------|---|
|  | 2015                             | 2014   | \$ Change | % Change |   |
|  | (Dollars in Thousands)           |        |           |          |   |
| Service charges on loans and deposits              | \$364                            | 317    | 47        | 14.8     | % |
| Increase in cash surrender value of life insurance | 636                              | 630    | 6         | 1.0      | % |
| Mortgage banking income                            | 26,708                           | 22,053 | 4,655     | 21.1     | % |
| Gain on sale of available for sale securities      | -                                | -      | -         | N/       | M |
| Other  | 843                              | 911    | (68 )     | (7.5 )   | % |
| Total noninterest income                           | \$28,551                         | 23,911 | 4,640     | 19.4     | % |
| N/M - Not meaningful                               |                                  |        |           |          |   |

Total noninterest income increased \$4.6 million, or 19.4%, to \$28.6 million during the three months ended September 30, 2015 compared to \$23.9 million during the three months ended September 30, 2014. The increase resulted primarily from an increase in mortgage banking income.

The increase in mortgage banking income was the result of an increase in purchase volumes and margins. The volume increased \$60.2 million, or 12.3%, to \$550.0 million during the three months ended September 30, 2015 compared to \$489.8 million during the three months ended September 30, 2014.

The increase in service charges on loans and deposits was related to an increase in loan prepayment penalties.

The decrease in other noninterest income was primarily due to a decrease in the sale of mortgage servicing rights.

During the three months ended September 30, 2015, total sales resulted in a gain of \$544,000 compared to a gain of \$607,000 during the three months ended September 30, 2014.

Noninterest Expenses

|  | Three months ended September 30, |        |           |          |   |
|--|----------------------------------|--------|-----------|----------|---|
|  | 2015                             | 2014   | \$ Change | % Change |   |
|  | (Dollars in Thousands)           |        |           |          |   |
| Compensation, payroll taxes, and other employee benefits | \$21,234                         | 18,169 | 3,065     | 16.9     | % |
| Occupancy, office furniture and equipment                | 2,292                            | 2,577  | (285 )    | (11.1 )  | % |
| Advertising  | 755                              | 678    | 77        | 11.4     | % |
| Data processing  | 592                              | 582    | 10        | 1.7      | % |
| Communications   | 332                              | 430    | (98 )     | (22.8 )  | % |

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|                            |          |        |        |         |   |
|----------------------------|----------|--------|--------|---------|---|
| Professional fees          | 642      | 441    | 201    | 45.6    | % |
| Real estate owned          | 646      | 665    | (19 )  | (2.9 )  | % |
| FDIC insurance premiums    | 243      | 336    | (93 )  | (27.7 ) | % |
| Other                      | 3,050    | 3,152  | (102 ) | (3.2 )  | % |
| Total noninterest expenses | \$29,786 | 27,030 | 2,756  | 10.2    | % |

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Total noninterest expenses increased \$2.8 million, or 10.2%, to \$29.8 million during the three months ended September 30, 2015 compared to \$27.0 million during the three months ended September 30, 2014.

Compensation, payroll taxes and other employee benefit expense increased \$3.1 million primarily due to a \$2.4 million increase in compensation, payroll taxes and other benefits within our mortgage banking segment. The increase in compensation within our mortgage banking segment correlates to the increase in mortgage banking income due to the commission-based compensation structure in place for our mortgage banking loan officers. Compensation, payroll taxes and other employee benefit expense increased \$632,000 within the community banking segment primarily due to stock awards granted in 2015 and raises, while full time equivalent levels remain relatively flat.

Occupancy, office furniture and equipment expense decreased resulting from less rent expense in the three months ended September 30, 2015 compared to the same period during the prior year due to the closing of underperforming mortgage branches.

Professional fees expense increased in the three months ended September 30, 2015 compared to the same period during the prior year due to slightly higher consulting and legal fees.

FDIC insurance premiums expense decreased resulting from a lower assessment rate due to improved asset quality in the three months ended September 30, 2015 compared to the same period during the prior year.

Other noninterest expense decreased primarily due to a reduced provision for mortgage banking segment branch losses due to increased profitability with high mortgage volumes and continued focus on controlling expenses.

### Income Taxes

Driven by an increase in pre-tax income, income tax expense increased \$181,000, or 6.7%, to \$2.9 million during the three months ended September 30, 2015, compared to \$2.7 million during the three months ended September 30, 2014. Income tax expense was recognized during the three months ended September 30, 2015 at an effective rate of 35.8% compared to an effective rate of 36.3% during the three months ended September 30, 2014.

### Comparison of Community Banking Segment for the Nine Months Ended September 30, 2015 and 2014

Net income for the nine months ended September 30, 2015 totaled \$6.5 million compared to net income of \$8.0 million for the nine months ended September 30, 2014. Net interest income decreased \$1.4 million to \$28.5 million for the nine months ended September 30, 2015 compared to \$29.9 million for the nine months ended September 30, 2014. Provision for loan loss increased \$700,000. Compensation, payroll taxes, and other employee benefits expense increased \$2.0 million primarily due to the grant of stock awards during 2015. The increase in compensation was partially offset by a reduction in all other expense categories for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014.

### Comparison of Mortgage Banking Segment Operations for the Nine Months Ended September 30, 2015 and 2014

Net income totaled \$7.1 million for the nine months ended September 30, 2015, compared to \$2.3 million during the nine months ended September 30, 2014. Mortgage banking segment revenues increased \$17.1 million, or 27.5%, to \$79.2 million for the nine months ended September 30, 2015 compared to \$62.1 million for the nine months ended September 30, 2014. The increase in revenue was attributable to a 22.9% increase in volume origination to \$1.5 billion during the nine months ended September 30, 2015 compared to \$1.3 billion during the nine months ended September 30, 2014. While revenue increased 27.5%, noninterest expenses increased \$8.4 million, or 14.3%, to \$67.4 million for the nine months ended September 30, 2015 compared to \$59.0 million for the nine months ended September 30, 2014. The improvement was due to ongoing expense control efforts.

### Consolidated Waterstone Financial, Inc. Results of Operations

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Nine months ended  
September 30,  
2015      2014  
(Dollars in  
Thousands, except  
per share amounts)

|                                     |          |        |
|-------------------------------------|----------|--------|
| Net income                          | \$13,498 | 10,418 |
| Earnings per share - basic          | 0.45     | 0.31   |
| Earnings per share - diluted        | 0.45     | 0.31   |
| Annualized return on average assets | 1.03 %   | 0.78 % |
| Annualized return on average equity | 4.26 %   | 3.18 % |

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Average Balance Sheets, Interest and Yields/Costs

The following tables set forth average balance sheets, annualized average yields and costs, and certain other information for the periods indicated. Non-accrual loans were included in the computation of the average balances of loans receivable and held for sale. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense. Yields on interest-earning assets are computed on a fully tax-equivalent yield, where applicable.

|   | Nine months ended September 30, |          |            |               |          |            |   |  |  |
|---|---------------------------------|----------|------------|---------------|----------|------------|---|--|--|
|   | 2015                            |          |            | 2014          |          |            |   |  |  |
|   | Average                         | Interest | Yield/Cost | Average       | Interest | Yield/Cost |   |  |  |
|   | Balance                         |          |            | Balance       |          |            |   |  |  |
|   | (Dollars in Thousands)          |          |            |               |          |            |   |  |  |
| <b>Assets</b>   |                                 |          |            |               |          |            |   |  |  |
| <b>Interest-earning assets:</b>   |                                 |          |            |               |          |            |   |  |  |
| Loans receivable and held for sale (1)                                  | \$1,223,971                     | 41,495   | 4.53       | % \$1,231,540 | 43,178   | 4.69       | % |  |  |
| Mortgage related securities (2)   | 172,548                         | 2,451    | 1.90       | % 158,869     | 2,142    | 1.80       | % |  |  |
| Debt securities, federal funds sold and short-term investments (2)(3)   | 255,284                         | 3,306    | 1.73       | % 312,961     | 3,104    | 1.33       | % |  |  |
| Total interest-earning assets   | 1,651,803                       | 47,252   | 3.82       | % 1,703,370   | 48,424   | 3.80       | % |  |  |
| Noninterest-earning assets  | 102,558                         |          |            | 93,184        |          |            |   |  |  |
| Total assets  | \$1,754,361                     |          |            | \$1,796,554   |          |            |   |  |  |
| <b>Liabilities and equity</b>   |                                 |          |            |               |          |            |   |  |  |
| <b>Interest-bearing liabilities:</b>                                    |                                 |          |            |               |          |            |   |  |  |
| Demand accounts   | \$30,804                        | 15       | 0.07       | % \$45,693    | 11       | 0.03       | % |  |  |
| Money market and savings accounts                                       | 137,016                         | 116      | 0.11       | % 166,380     | 82       | 0.07       | % |  |  |
| Time deposits   | 639,049                         | 4,120    | 0.86       | % 634,417     | 3,429    | 0.72       | % |  |  |
| Total interest-bearing deposits   | 806,869                         | 4,251    | 0.70       | % 846,490     | 3,522    | 0.56       | % |  |  |
| Borrowings  | 438,767                         | 12,898   | 3.93       | % 445,537     | 13,048   | 3.92       | % |  |  |
| Total interest-bearing liabilities                                      | 1,245,636                       | 17,149   | 1.84       | % 1,292,027   | 16,570   | 1.71       | % |  |  |
| <b>Noninterest-bearing liabilities</b>                                  |                                 |          |            |               |          |            |   |  |  |
| Noninterest-bearing deposits  | 64,945                          |          |            | 44,293        |          |            |   |  |  |
| Other noninterest-bearing liabilities                                   | 20,532                          |          |            | 21,916        |          |            |   |  |  |
| Total noninterest-bearing liabilities                                   | 85,477                          |          |            | 66,209        |          |            |   |  |  |
| Total liabilities   | 1,331,113                       |          |            | 1,358,236     |          |            |   |  |  |
| Equity  | 423,248                         |          |            | 438,318       |          |            |   |  |  |
| Total liabilities and equity  | \$1,754,361                     |          |            | \$1,796,554   |          |            |   |  |  |
| Net interest income   |                                 | 30,103   |            |               | 31,854   |            |   |  |  |
| Net interest rate spread (4)  |                                 |          | 1.98       | %             |          | 2.09       | % |  |  |
| Less: taxable equivalent adjustment                                     |                                 | 697      |            |               | 630      |            |   |  |  |
| Net interest income, as reported  |                                 | 29,406   |            |               | 31,224   |            |   |  |  |
| Net interest-earning assets (5)   | \$406,167                       |          |            | \$411,343     |          |            |   |  |  |
| Net interest margin (6)   |                                 |          | 2.38       | %             |          | 2.45       | % |  |  |
| Tax equivalent effect   |                                 |          | 0.06       | %             |          | 0.05       | % |  |  |
| Net interest margin on a fully tax equivalent basis (6)                 |                                 |          | 2.44       | %             |          | 2.50       | % |  |  |
| Average interest-earning assets to average interest-bearing liabilities |                                 |          | 132.61     | %             |          | 131.84     | % |  |  |



- 
- (1) Interest income includes net deferred loan fee amortization income of \$420,000 and \$461,000 for the nine months ended September 30, 2015 and 2014, respectively.
  - (2) Average balance of mortgage related and debt securities are based on amortized historical cost.
  - (3) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented. The yields on debt securities, federal funds sold and short-term investments before tax-equivalent adjustments were 1.37% and 1.06% for the nine months ended September 30, 2015 and 2014, respectively.
  - (4) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities and is presented on a fully tax equivalent basis.
  - (5) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
  - (6) Net interest margin represents net interest income divided by average total interest-earning assets.

## Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

|   | Nine months ended<br>September 30,<br>2015 versus 2014<br>Increase (Decrease) due<br>to |         |         |
|---|---|---------|---------|
|   | Volume  | Rate    | Net     |
|   | (In Thousands)  |         |         |
| Interest income:                          |   |         |         |
| Loans receivable and held for sale (1)(2) | \$(269)   | (1,414) | (1,683) |
| Mortgage related securities (3)           | 209   | 100     | 309     |
| Other earning assets (3) (4)              | (640)   | 842     | 202     |
| Total interest-earning assets             | (700)   | (472 )  | (1,172) |
| Interest expense:                         |   |         |         |
| Demand accounts                           | (5 )  | 9       | 4       |
| Money market and savings accounts         | (17 )   | 51      | 34      |
| Time deposits                             | 25  | 666     | 691     |
| Total interest-earning deposits           | 3   | 726     | 729     |
| Borrowings                                | (199)   | 49      | (150 )  |
| Total interest-bearing liabilities        | (196)   | 775     | 579     |
| Net change in net interest income         | \$(504)   | (1,247) | (1,751) |

(1) Interest income includes net deferred loan fee amortization income of \$420,000 and \$461,000 for the nine months ended September 30, 2015 and 2014, respectively.

(2) Non-accrual loans have been included in average loans receivable balance.

(3) Includes available for sale securities. Average balance of available for sale securities is based on amortized historical cost.

(4) Interest income from tax exempt securities is computed on a taxable equivalent basis using a tax rate of 35% for all periods presented.

Net interest income decreased \$1.8 million, or 5.8%, to \$29.4 million during the nine months ended September 30, 2015 compared to \$31.2 million during the nine months ended September 30, 2014.

· Interest income on loans decreased due to a 16 basis point decrease in average yield on loans.

Interest income from mortgage related securities increased due to an increase in the average balance of mortgage related securities. Funds received from the second step offering completed in January 2014 were used to purchase additional securities throughout 2014.

· Interest income from other interest earning assets (comprised of debt securities, federal funds sold and short-term investments) increased slightly due to an increase in higher yielding municipal securities balances in 2015 compared to cash being held in 2014. The decrease in average balance reflects utilization of the \$248.3 million in net proceeds

that were received from our stock offering during January 2014 to purchase securities, fund loans held for sale, and repurchase shares.

Interest expense on deposits increased primarily due to an increase in the average cost of time deposits of 14 basis points along with a slightly higher average balance of time deposits.

Interest expense on borrowings decreased slightly due to the decreased use of short-term repurchase agreements within our mortgage banking segment to fund loan originations to be sold in the secondary market during the nine months ended September 30, 2015.

Provision for Loan Losses

Our provision for loan losses increased \$870,000, or 102.4%, to \$1.7 million during the nine months ended September 30, 2015, from \$850,000 during the nine months ended September 30, 2014. The increase was largely related to two loans collateralized by out-of-state single-family properties and one loan collateralized by a multi-family property.

The provision is primarily a function of the Company's reserving methodology and assessments of certain quantitative and qualitative factors which are used to determine an appropriate allowance for loan losses for the period. See further discussion regarding the allowance for loan losses in the "Asset Quality" section for an analysis of charge-offs, nonperforming assets, specific reserves and additional provisions and the "Allowance for Loan Loss" section.

Noninterest Income

|  | Nine months ended September 30, |        |           |          |    |
|--|---------------------------------|--------|-----------|----------|----|
|  | 2015                            | 2014   | \$ Change | % Change |    |
|  | (Dollars in Thousands)          |        |           |          |    |
| Service charges on loans and deposits              | \$1,213                         | 904    | 309       | 34.2     | %  |
| Increase in cash surrender value of life insurance | 1,195                           | 1,082  | 113       | 10.4     | %  |
| Mortgage banking income                            | 77,324                          | 58,743 | 18,581    | 31.6     | %  |
| Gain on sale of available for sale securities      | 44                              | -      | 44        | N/       | M  |
| Other  | 1,848                           | 3,436  | (1,588 )  | (46.2    | )% |
| Total noninterest income                           | \$81,624                        | 64,165 | 17,459    | 27.2     | %  |
| N/M - Not meaningful                               |                                 |        |           |          |    |

Total noninterest income increased \$17.5 million, or 27.2%, to \$81.6 million during the nine months ended September 30, 2015 compared to \$64.2 million during the nine months ended September 30, 2014. The increase resulted primarily from an increase in mortgage banking income offset by a decrease in other noninterest income.

The increase in mortgage banking income was the result of an increase in origination volumes and margins. The volume increased \$288.3 million, or 22.9%, to \$1.5 billion during the nine months ended September 30, 2015 compared to a \$1.3 billion during the nine months ended September 30, 2014.

The increase in service charges on loans and deposits was related to an increase in loan prepayment penalties. The increase in cash surrender value of life insurance was related to the additional earnings on the \$10.0 million policy purchased in May 2014.

The Company sold one municipal security at a gain in the current period compared to none in the prior year period. The decrease in other noninterest income was primarily due to a decrease in the sale of mortgage servicing rights which resulted in an \$807,000 gain during the nine months ended September 30, 2015 compared to a \$2.4 million gain on sales of mortgage servicing rights during the nine months ended September 30, 2014.

Noninterest Expenses

|  | Nine months ended September 30, |        |           |          |   |
|--|---------------------------------|--------|-----------|----------|---|
|  | 2015                            | 2014   | \$ Change | % Change |   |
|  | (Dollars in Thousands)          |        |           |          |   |
| Compensation, payroll taxes, and other employee benefits | \$62,584                        | 51,418 | 11,166    | 21.7     | % |

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|   |          |        |        |          |
|---|----------|--------|--------|----------|
| Occupancy, office furniture and equipment | 7,004    | 7,883  | (879 ) | (11.2 )% |
| Advertising                               | 2,120    | 2,252  | (132 ) | (5.9 )%  |
| Data processing                           | 1,797    | 1,701  | 96     | 5.6 %    |
| Communications                            | 1,053    | 1,250  | (197 ) | (15.8 )% |
| Professional fees                         | 1,771    | 1,471  | 300    | 20.4 %   |
| Real estate owned                         | 1,875    | 1,918  | (43 )  | (2.2 )%  |
| FDIC insurance premiums                   | 851      | 1,046  | (195 ) | (18.6 )% |
| Other                                     | 9,106    | 9,325  | (219 ) | (2.3 )%  |
| Total noninterest expenses                | \$88,161 | 78,264 | 9,897  | 12.6 %   |

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Total noninterest expenses increased \$9.9 million, or 12.6%, to \$88.2 million during the nine months ended September 30, 2015 compared to \$78.3 million during the nine months ended September 30, 2014.

Compensation, payroll taxes and other employee benefit expense increased \$11.2 million primarily due to a \$9.3 million increase in compensation, payroll taxes and other benefits within our mortgage banking segment. The increase in compensation within our mortgage banking segment correlates to the increase in mortgage banking income due to the commission-based compensation structure in place for our mortgage banking loan officers. Compensation, payroll taxes and other employee benefit expense increased \$2.0 million within the community banking segment primarily due to stock awards granted in 2015 and raises, while full time equivalent levels remain relatively flat.

Occupancy, office furniture and equipment expense decreased resulting from less rent expense in the current year compared to prior year due to closing underperforming mortgage banking segment branches during the first half of 2014. Additionally, there was less snow removal expense in the nine months ended September 30, 2015 compared to the same period during the prior year.

Advertising expense decreased as a result of mortgage banking segment branches closing in 2014 and improved expense management at our mortgage banking segment.

Professional fees expense increased as a result of an increase in legal fees.

Real estate owned expense decreased \$43,000. Real estate owned writedowns increased \$515,000 to \$1.5 million facilitating a plan to liquidate certain aged properties. Net gain on sales increased \$680,000 as certain other property values have improved. Net real estate owned expenses increased \$121,000.

FDIC insurance premiums decreased due to a decrease in our assessment rate in 2015 compared to 2014 due to improved asset quality and as capital increased.

Other noninterest expense decreased primarily due to a reduced provision for mortgage banking segment branch losses due to increased profitability with high mortgage volumes and continued focus on controlling expenses.

### Income Taxes

Driven by an increase in pre-tax income, income tax expense increased \$1.8 million, or 30.6%, to \$7.7 million during the nine months ended September 30, 2015, compared to \$5.9 million during the nine months ended September 30, 2014. Income tax expense was recognized during the nine months ended September 30, 2015 at an effective rate of 36.2% compared to an effective rate of 36.0% during the nine months ended September 30, 2014.

### Comparison of Financial Condition at September 30, 2015 and December 31, 2014

Total Assets - Total assets decreased by \$38.7 million, or 2.2%, to \$1.74 billion at September 30, 2015 from \$1.78 billion at December 31, 2014. The decrease in total assets is primarily due to the stock buyback program.

Cash and Cash Equivalents - Cash and cash equivalents decreased \$42.4 million, or 24.5%, to \$130.4 million at September 30, 2015, compared to \$172.8 million at December 31, 2014. The decrease in cash and cash equivalents primarily reflects the increase in loans held for sale, repurchase of shares, and slight increase in loans receivable. Offsetting these reductions to cash and cash equivalents, advanced payments by borrowers for taxes increased, securities available for sale decreased, and deposits increased from December 31, 2014.

Securities Available for Sale - Securities available for sale decreased \$15.9 million at September 30, 2015 compared to December 31, 2014. The decrease was due to paydowns in mortgage related securities and maturities of municipal bonds and offset by the purchase of a corporate bond security.

Loans Held for Sale - Loans held for sale increased at September 30, 2015 due to increased volumes at our mortgage subsidiary compared to the fourth quarter of 2014.



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**Loans Receivable** - Loans receivable held for investment increased \$5.7 million to \$1.10 billion at September 30, 2015 compared to December 31, 2014. The increase in total loans receivable was primarily attributable to increases in the multi-family and commercial real estate loan portfolio categories as the Bank continues to focus on those areas for growth. Offsetting those increases, the one- to four-family and home equity categories decreased consistent with market conditions.

The following table shows loan origination, loan purchases, principal repayment activity, transfers to real estate owned, charge-offs and sales during the periods indicated.

|   | As of or for the<br>Nine months ended<br>September 30, |             | As of or for<br>the<br>Year Ended<br>December<br>31, 2014 |
|---|--|-------------|---|
|   | 2015   | 2014        |   |
|   | (In Thousands)   |             |   |
| Total gross loans receivable and held for sale at beginning of period | \$1,220,063  | 1,189,697   | 1,189,697   |
| Real estate loans originated for investment:                          |  |             |   |
| Residential   |  |             |   |
| One- to four-family   | 32,286   | 33,261      | 48,325  |
| Multi-family  | 76,695   | 71,091      | 88,958  |
| Home equity   | 5,441  | 3,025       | 4,177   |
| Construction and land   | 11,085   | 1,124       | 8,806   |
| Commercial real estate  | 35,365   | 25,000      | 29,294  |
| Total real estate loans originated for investment                     | 160,872  | 133,501     | 179,560   |
| Consumer loans originated for investment                              | 688  | 10          | 10  |
| Commercial business loans originated for investment                   | 14,662   | 6,366       | 7,863   |
| Total loans originated for investment                                 | 176,222  | 139,877     | 187,433   |
| Principal repayments  | (153,938 )   | (100,956 )  | (159,619 )  |
| Transfers to real estate owned  | (11,719 )  | (13,423 )   | (16,645 )   |
| Loan principal charged-off  | (4,914 )   | (6,455 )    | (8,855 )  |
| Net activity in loans held for investment                             | 5,651  | 19,043      | 2,314   |
| Loans originated for sale   | 1,545,098  | 1,256,795   | 1,661,376   |
| Loans sold  | (1,528,363)  | (1,209,623) | (1,633,324)   |
| Net activity in loans held for sale                                   | 16,735   | 47,172      | 28,052  |
| Total gross loans receivable and held for sale at end of period       | \$1,242,449  | 1,255,912   | 1,220,063   |

**Allowance for Loan Losses** - The allowance for loan losses decreased at September 30, 2015 from December 31, 2014. The decrease resulted from the charge-off of specific reserves and improvement of key loan quality metrics decreasing the allowance related to the loans collectively reviewed. The overall decrease were primarily related to the one- to four-family and multi-family categories. The other remaining categories were relatively consistent with the amounts at December 31, 2014.

**Real Estate Owned** – Total real estate owned decreased \$6.6 million from December 31, 2014. During the nine months ended September 30, 2015, \$11.8 million was transferred from loans receivable to real estate owned upon completion of foreclosure. During the same period, sales of real estate owned totaled \$17.3 million. In an effort to sell older



properties, list prices were dropped which resulted in \$1.5 million in write downs during the nine months ended September 30, 2015.

Deposits – Total deposits increased \$9.2 million to \$873.2 million at September 30, 2015 from December 31, 2014. The increase was driven by an increase in more cost effective transaction accounts partially offset by a decrease in time deposits.

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Borrowings – Total borrowings remained constant at \$434.0 million at September 30, 2015 and December 31, 2014.

Advance Payments by Borrowers for Taxes - Advance payments by borrowers for taxes increased \$18.8 million. The increase was the result of payments received from borrowers for their real estate taxes and is seasonally normal, as balances increase during the course of the calendar year until real estate tax obligations are paid out in the fourth quarter.

Other Liabilities - Other liabilities decreased \$7.1 million at September 30, 2015 compared to December 31, 2014. Of the total decrease, \$9.7 million related to a seasonal decrease in outstanding checks related to advance payments by borrowers for taxes. The Company receives payments from borrowers for their real estate taxes during the course of the calendar year until real estate tax obligations are paid out in the fourth quarter. At the time at which the disbursements are made, the outstanding checks are classified as other liabilities. These amounts remain classified as other liabilities until settled. The accrued compensation and accounts payable for the mortgage banking segment increased \$1.8 million and \$1.5 million, respectively, from December 31, 2014, driven by increased loan origination volumes.

Shareholders' Equity – Shareholders' equity decreased by \$59.6 million, or 13.2%, to \$390.6 million at September 30, 2015 from December 31, 2014. The decrease in shareholders' equity was due to the stock repurchase programs initiated during the nine months ended September 30, 2015, and dividends declared. These decreases were offset by net income, vesting of ESOP, and the stock compensation awards.

## ASSET QUALITY

### NONPERFORMING ASSETS

|                                      | At<br>September<br>30,<br>2015 | At<br>December<br>31,<br>2014 |
|--------------------------------------|--------------------------------|-------------------------------|
|                                      | (Dollars in<br>Thousands)      |                               |
| Non-accrual loans:                   |                                |                               |
| Residential                          |                                |                               |
| One- to four-family                  | \$16,051                       | 23,918                        |
| Multi-family                         | 4,785                          | 12,001                        |
| Home equity                          | 313                            | 445                           |
| Construction and land                | 350                            | 401                           |
| Commercial real estate               | 321                            | 947                           |
| Commercial                           | 31                             | 299                           |
| Consumer                             | -                              | -                             |
| Total non-accrual loans              | 21,851                         | 38,011                        |
| Real estate owned                    |                                |                               |
| One- to four-family                  | 6,109                          | 10,896                        |
| Multi-family                         | 1,214                          | 2,210                         |
| Construction and land                | 5,206                          | 5,400                         |
| Commercial real estate               | 300                            | 300                           |
| Total real estate owned              | 12,829                         | 18,806                        |
| Valuation allowance at end of period | (673 )                         | (100 )                        |

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|   |          |        |      |   |
|---|----------|--------|------|---|
| Total real estate owned, net                | 12,156   | 18,706 |      |   |
| Total nonperforming assets                  | \$34,007 | 56,717 |      |   |
| Total non-accrual loans to total loans, net | 1.99     | %      | 3.47 | % |
| Total non-accrual loans to total assets     | 1.25     | %      | 2.13 | % |
| Total nonperforming assets to total assets  | 1.95     | %      | 3.18 | % |

All loans that exceed 90 days past due with respect to principal and interest are recognized as non-accrual. Troubled debt restructurings that are non-accrual either due to being past due greater than 90 days or which have not yet performed under the modified terms for a reasonable period of time, are included in the table above. In addition, loans that are past due less than 90 days are evaluated to determine the likelihood of collectability given other credit risk factors such as early stage delinquency, the nature of the collateral or the results of a borrower review. When the collection of all contractual principal and interest is determined to be unlikely, the loan is moved to non-accrual status and an updated appraisal of the underlying collateral is ordered. This process generally takes place when a loan is contractually past due between 60 and 90 days. Upon determining the updated estimated value of the collateral, a loan loss provision is recorded to establish a specific reserve to the extent that the outstanding principal balance exceeds the updated estimated net realizable value of the collateral. When a loan is determined to be uncollectible, typically coinciding with the initiation of foreclosure action, the specific reserve is reviewed for adequacy, adjusted if necessary, and charged-off.

The following table sets forth activity in our non-accrual loans for the periods indicated.

|                                | At or for the Nine<br>Months<br>Ended September<br>30, |          |
|--------------------------------|--|----------|
|                                | 2015   | 2014     |
|                                | (In Thousands)   |          |
| Balance at beginning of period | \$38,011   | 50,961   |
| Additions                      | 8,710  | 20,902   |
| Transfers to real estate owned | (11,719)   | (13,423) |
| Charge-offs                    | (3,161 )   | (4,897 ) |
| Returned to accrual status     | (5,242 )   | (3,755 ) |
| Principal paydowns and other   | (4,748 )   | (6,652 ) |
| Balance at end of period       | \$21,851   | 43,136   |

Total non-accrual loans decreased by \$16.2 million, or 42.5%, to \$21.9 million as of September 30, 2015 compared to \$38.0 million as of December 31, 2014. The ratio of non-accrual loans to total loans receivable was 1.99% at September 30, 2015 compared to 3.47% at December 31, 2014. During the nine months ended September 30, 2015, \$11.7 million in non-accrual loans were transferred to real estate owned, \$3.2 million in loan principal was charged off, \$5.2 million in loans were returned to accrual status and approximately \$4.7 million in principal payments were received. Offsetting this activity, \$8.7 million in loans were placed on non-accrual status during the nine months ended September 30, 2015.

Of the \$21.9 million in total non-accrual loans as of September 30, 2015, \$20.6 million in loans have been specifically reviewed to assess whether a specific valuation allowance is necessary. A specific valuation allowance is established for an amount equal to the impairment when the carrying value of the loan exceeds the present value of expected future cash flows, discounted at the loan's original effective interest rate or the fair value of the underlying collateral with an adjustment made for costs to dispose of the asset. Based upon these specific reviews, a total of \$5.8 million in cumulative partial charge-offs have been recorded with respect to these loans as of September 30, 2015. Partially charged-off loans measured for impairment based upon net realizable collateral value are maintained in a "non-performing" status and are disclosed as impaired loans. In addition, specific reserves totaling \$1.7 million have been recorded as of September 30, 2015. The remaining \$1.3 million of non-accrual loans were reviewed on an aggregate basis and \$256,000 in general valuation allowance was deemed necessary related to those loans as of September 30, 2015. The \$256,000 in valuation allowance is based upon a migration analysis performed with respect to similar non-accrual loans in prior periods.

Our largest non-accrual loan was collateralized by single-family residential real estate. This loan had a principal balance of \$1.3 million, which is net of life-to-date charge-offs of \$865,000 at September 30, 2015. Our second largest non-accrual loan was collateralized by multi-family residential real estate. This loan had a principal balance of \$1.3 million, which is net of life-to-date charge-offs of \$102,000 at September 30, 2015, as well as a specific reserve of \$440,000. Our third largest non-accrual loan as of September 30, 2015 was collateralized by multi-family residential real estate. This loan had a principal balance of \$1.2 million, which is net of life-to-date charge-offs of \$948,000 at September 30, 2015. Our fourth largest non-accrual loan as of September 30, 2015 was collateralized by single-family residential real estate. This loan had a principal balance of \$1.1 million, which is net of life-to-date charge-offs of \$833,000, at September 30, 2015. Our fifth largest non-accrual loan as of September 30, 2015 was collateralized by two- to four- family residential real estate. This loan had a principal balance of \$865,000 at September 30, 2015 and has a specific reserve of \$107,000. Together, these five largest non-accrual loans comprised 26.3% of total non-accrual loans at September 30, 2015.

For the nine months ended September 30, 2015, gross interest income that would have been recorded had our non-accruing loans been current in accordance with their original terms was \$1.1 million. We received \$718,000 of interest payments on such loans during the nine months ended September 30, 2015. Interest payments received are treated as interest income on a cash basis as long as the remaining book value of the loan (i.e., after charge-off of all identified losses) is deemed to be fully collectible. If the remaining book value is not deemed to be fully collectible, all payments received are applied to unpaid principal. Determination as to the ultimate collectability of the remaining book value is supported by an updated credit department evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's sustained historical repayment performance and other relevant factors.

There were no accruing loans past due 90 days or more during the nine months ended September 30, 2015 or 2014.

## TROUBLED DEBT RESTRUCTURINGS

The following table summarizes information with respect to the accrual status of our troubled debt restructurings:

|                        | As of September 30, 2015 |              |        |
|------------------------|--------------------------|--------------|--------|
|                        | Accruing                 | Non-accruing | Total  |
|                        | (In Thousands)           |              |        |
| One- to four-family    | \$3,905                  | 5,810        | 9,715  |
| Multi-family           | 2,795                    | 2,300        | 5,095  |
| Home equity            | -                        | 98           | 98     |
| Construction and land  | 1,636                    | -            | 1,636  |
| Commercial real estate | 1,306                    | 77           | 1,383  |
|                        | \$9,642                  | 8,285        | 17,927 |
|                        | As of December 31, 2014  |              |        |
|                        | Accruing                 | Non-accruing | Total  |
| One- to four-family    | \$4,724                  | 10,233       | 14,957 |
| Multi-family           | 2,923                    | 4,797        | 7,720  |
| Home equity            | -                        | 98           | 98     |
| Construction and land  | 1,866                    | -            | 1,866  |
| Commercial real estate | 1,306                    | 170          | 1,476  |
|                        | \$10,819                 | 15,298       | 26,117 |

All troubled debt restructurings are considered to be impaired and are risk rated as either substandard or watch and are included in the internal risk rating tables disclosed in the notes to the financial statements. Specific reserves have been established to the extent that collateral-based impairment analyses indicate that a collateral shortfall exists.

We do not participate in government-sponsored troubled debt restructuring programs. Our troubled debt restructurings are short-term modifications. Typical initial restructured terms include six to twelve months of principal forbearance, a reduction in interest rate or both. Restructured terms do not include a reduction of the outstanding principal balance unless mandated by a bankruptcy court. Troubled debt restructuring terms may be renewed or further modified at the end of the initial term for an additional period if performance has been acceptable and the short-term borrower difficulty persists.

If a restructured loan is current in all respects and a minimum of six consecutive restructured payments have been received, it can be considered for return to accrual status. After a restructured loan that is current in all respects reverts to contractual/market terms, if a credit department review indicates no evidence of elevated market risk, the loan is removed from the troubled debt restructuring classification.

## LOAN DELINQUENCY

The following table summarizes loan delinquency in total dollars and as a percentage of the total loan portfolio:

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|  | At<br>September<br>30,<br>2015 | At<br>December<br>31,<br>2014 |      |   |
|--|--------------------------------|-------------------------------|------|---|
|  | (Dollars in<br>Thousands)      |                               |      |   |
| Loans past due less than 90 days               | \$3,294                        | 9,022                         |      |   |
| Loans past due 90 days or more                 | 12,368                         | 25,112                        |      |   |
| Total loans past due                           | \$15,662                       | 34,134                        |      |   |
| <br>   |                                |                               |      |   |
| Total loans past due to total loans receivable | 1.42                           | %                             | 3.12 | % |

Past due loans decreased by \$18.5 million, or 54.1%, to \$15.7 million at September 30, 2015 from \$34.1 million at December 31, 2014. Loans past due 90 days or more decreased by \$12.7 million, or 50.7%, during the nine months ended September 30, 2015 and loans past due less than 90 days decreased by \$5.7 million, or 63.5%. The \$12.7 million decrease in loans past due 90 days or more was primarily due to \$11.7 million in loans transferred to real estate owned during the nine months ended September 30, 2015 offset by additional loans which were included in the less than 90 day group in the previous period. The \$5.7 million decrease in loans past due less than 90 days or more was primarily attributable to a decrease in delinquent loans collateralized by one- to four-family loans as one significant relationship entered the past 90 days due category, in addition to more loans returning to current status and less new loans entering past due status.

## REAL ESTATE OWNED

Total real estate owned decreased by \$6.6 million, or 35.0%, to \$12.2 million at September 30, 2015, compared to \$18.7 million at December 31, 2014. During the nine months ended September 30, 2015, \$11.7 million was transferred from loans to real estate owned upon completion of foreclosure including a \$1.6 million relationship, a \$1.5 million relationship, and a \$1.2 million relationship. During the same period, sales of real estate owned totaled \$17.3 million. In an effort to sell older properties, list prices were dropped which resulted in \$1.5 million in write downs during the nine months ended September 30, 2015. New appraisals received on real estate owned and collateral dependent impaired loans are based upon an "as is value" assumption. During the period of time in which we are awaiting receipt of an updated appraisal, loans evaluated for impairment based upon collateral value are measured by the following:

- Applying an updated adjustment factor (as described previously) to an existing appraisal;
- Confirming that the physical condition of the real estate has not significantly changed since the last valuation date;
- Comparing the estimated current value of the collateral to that of updated sales values experienced on similar collateral;
- Comparing the estimated current value of the collateral to that of updated values seen on current appraisals of similar collateral; and
- Comparing the estimated current value to that of updated listed sales prices on our real estate owned and that of similar properties (not owned by the Company).

Virtually all habitable real estate owned is managed with the intent of attracting a lessee to generate revenue. Foreclosed properties are recorded at the lower of carrying value or fair value, less costs to sell, with charge-offs, if any, charged to the allowance for loan losses upon transfer to real estate owned. The fair value is primarily based upon updated appraisals in addition to an analysis of current real estate market conditions.

## ALLOWANCE FOR LOAN LOSSES

|                                | At or for the Nine<br>Months<br>Ended September<br>30,<br>2015      2014<br>(Dollars in<br>Thousands) |        |
|--------------------------------|---|--------|
| Balance at beginning of period | \$18,706  | 24,264 |
| Provision for loan losses      | 1,720   | 850    |
| Charge-offs:                   |   |        |
| Mortgage                       |   |        |
| One- to four-family            | 3,212   | 1,900  |
| Multi-family                   | 1,501   | 3,462  |
| Home equity                    | 72  | 191    |
| Commercial real estate         | 45  | 186    |
| Construction and land          | 84  | 418    |
| Consumer                       | -   | 5      |



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|   |          |         |  |
|---|----------|---------|--|
| Commercial  | -        | 293     |  |
| Total charge-offs   | 4,914    | 6,455   |  |
| Recoveries:   |          |         |  |
| Mortgage  |          |         |  |
| One- to four-family   | 436      | 1,652   |  |
| Multi-family  | 789      | 23      |  |
| Home equity   | 101      | 11      |  |
| Commercial real estate  | 40       | 23      |  |
| Construction and land   | 45       | 63      |  |
| Consumer  | 5        | 5       |  |
| Commercial  | -        | 3       |  |
| Total recoveries  | 1,416    | 1,780   |  |
| Net charge-offs   | 3,498    | 4,675   |  |
| Allowance at end of period  | \$16,928 | 20,439  |  |
| Ratios:   |          |         |  |
| Allowance for loan losses to non-accrual loans at end of period   | 77.47 %  | 47.38 % |  |
| Allowance for loan losses to loans receivable at end of period    | 1.54 %   | 1.84 %  |  |
| Net charge-offs to average loans outstanding (annualized)         | 0.43 %   | 0.56 %  |  |
| Current period provision for loan losses to net charge-offs       | 49.17 %  | 18.18 % |  |
| Net charge-offs (annualized) to beginning of the period allowance | 25.00 %  | 25.76 % |  |

At September 30, 2015, the allowance for loan losses was \$16.9 million, compared to \$18.7 million at December 31, 2014. The decrease in allowance for loan losses during the nine months ended September 30, 2015 reflects improvement in both the quality of the loan portfolio as well as stabilization in the overall local real estate market. The Company has experienced improvement in a number of key loan-related loan quality metrics compared to December 31, 2014, including impaired loans, substandard loans, loans contractually past due and non-accrual loans.

Net charge-offs totaled \$3.5 million, or an annualized 0.43% of average loans for the nine months ended September 30, 2015, compared to \$4.7 million, or an annualized 0.56% of average loans for the nine months ended September 30, 2014. Of the \$3.5 million in net charge-offs during the nine months ended September 30, 2015, approximately 99.7% of the activity related to loans secured by multi-family and single-family residential loans.

Our underwriting policies and procedures emphasize that credit decisions must rely on both the credit quality of the borrower and the estimated value of the underlying collateral. Credit quality is assured only when the estimated value of the collateral is objectively determined and is not subject to significant fluctuation.

The allowance for loan losses has been determined in accordance with GAAP. We are responsible for the timely and periodic determination of the amount of the allowance required. Future provisions for loan losses will continue to be based upon our assessment of the overall loan portfolio and the underlying collateral, trends in non-performing loans, current economic conditions and other relevant factors. To the best of management's knowledge, all probable losses have been provided for in the allowance for loan losses.

The establishment of the amount of the loan loss allowance inherently involves judgments by management as to the appropriateness of the allowance, which ultimately may or may not be correct. Higher than anticipated rates of loan default would likely result in a need to increase provisions in future years. See "Critical Accounting Policies" above for a discussion on the use of judgment in determining the amount of the allowance for loan losses.

#### Liquidity and Capital Resources

We maintain liquid assets at levels we consider adequate to meet our liquidity needs. We adjust our liquidity levels to fund loan commitments, repay our borrowings, fund deposit outflows and pay real estate taxes on mortgage loans. We also adjust liquidity as appropriate to meet asset and liability management objectives. The level of our liquidity position at any point in time is dependent upon the judgment of the senior management as supported by the Asset/Liability Committee. Liquidity is monitored on a daily, weekly and monthly basis using a variety of measurement tools and indicators.

Our primary sources of liquidity are deposits, amortization and repayment of loans, sales of loans held for sale, maturities of investment securities and other short-term investments, and earnings and funds provided from operations. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan repayments are greatly influenced by market interest rates, economic conditions, and rates offered by our competitors. We set the interest rates on our deposits to maintain a desired level of total deposits. In addition, we invest excess funds in short-term, interest-earning assets, which provide liquidity to meet lending requirements. Additional sources of liquidity used for the purpose of managing long- and short-term cash flows include advances from the FHLB.

During the nine months ended September 30, 2015 primary uses of cash and cash equivalents included: \$1.55 billion funding loans held for sale, \$72.2 million for the repurchase of common stock, \$15.9 million in purchases of mortgage related securities, \$20.9 million increase in net fundings of loans receivable (irrespective of loans transferred to real estate owned), \$10.0 million in purchases of debt securities, and \$4.5 million in dividends paid.

During the nine months ended September 30, 2015, primary sources of cash and cash equivalents included: \$1.60 billion in proceeds from the sale of loans held for sale, \$31.6 million in principal repayments on mortgage related securities, \$8.2 million from maturities and calls of debt securities, \$9.2 million increase in deposits, \$9.1 million in advanced payments by borrowers for taxes, and \$18.3 million from real estate owned sales.

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During the nine months ended September 30, 2014 primary uses of cash and cash equivalents included: \$1.26 billion in originations of loans held for sale, \$141.9 million in funds returned to stock subscribers, \$80.8 million in purchases of mortgage related securities, \$37.1 million in loan originations, net of principal payments, \$16.0 million in purchases of debt securities, \$10.2 million in purchase of bank owned life insurance, and \$22.9 million in funding ESOP.

During the nine months ended September 30, 2014, primary sources of cash and cash equivalents included: \$1.26 billion in proceeds from the sale of loans held for sale, \$20.7 million from principal repayments on mortgage related securities, \$20.7 million related to an increase in deposits, \$13.0 in maturities or calls of debt securities, and \$9.6 million in real estate owned sales.

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A portion of our liquidity consists of cash and cash equivalents, which are a product of our operating, investing and financing activities. At September 30, 2015 and 2014, respectively, \$130.4 million and \$141.3 million of our assets were invested in cash and cash equivalents. At September 30, 2015 cash and cash equivalents are comprised of the following: \$80.5 million in cash held at the Federal Reserve Bank and other depository institutions and \$49.9 million in federal funds sold and short-term investments. Our primary sources of cash are principal repayments on loans, proceeds from the calls and maturities of debt and mortgage-related securities, increases in deposit accounts and advances from the FHLBC.

Liquidity management is both a daily and longer-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLBC which provide an additional source of funds. At September 30, 2015, we had \$350.0 million in advances from the FHLBC with contractual maturity dates in 2016, 2017 or 2018. All advances are callable quarterly until maturity. As an additional source of funds, we also enter into repurchase agreements. At September 30, 2015, we had \$84.0 million in repurchase agreements. The repurchase agreements mature at various times in 2017, however, all are callable quarterly until maturity.

At September 30, 2015, we had outstanding commitments to originate loans receivable of \$34.7 million. In addition, at September 30, 2015, we had unfunded commitments under construction loans of \$25.8 million, unfunded commitments under business lines of credit of \$10.1 million and unfunded commitments under home equity lines of credit and standby letters of credit of \$15.1 million. At September 30, 2015 certificates of deposit scheduled to mature in one year or less totaled \$443.2 million. Based on prior experience, management believes that, subject to the Bank's funding needs, a significant portion of such deposits will remain with us, although there can be no assurance that this will be the case. In the event a significant portion of our deposits is not retained by us, we will have to utilize other funding sources, such as FHLBC advances, in order to maintain our level of assets. However, we cannot assure that such borrowings would be available on attractive terms, or at all, if and when needed. Alternatively, we could reduce our level of liquid assets, such as our cash and cash equivalents and securities available-for-sale in order to meet funding needs. In addition, the cost of such deposits may be significantly higher if market interest rates are higher or there is an increased amount of competition for deposits in our market area at the time of renewal.

#### Capital

Shareholders' equity decreased by \$59.6 million to \$390.6 million at September 30, 2015 from \$450.2 million December 31, 2014. The decrease in shareholders' equity was due to the \$72.1 million in stock repurchased during the first nine months and \$4.4 million for cash dividends. This decrease was offset by \$13.5 million in net income, \$2.3 million in stock compensation, and an increase due to ESOP shares committed to be released.

The Company's Board of Directors authorized a stock repurchase program in the first quarter of 2015. The Company authorized two stock repurchase programs in the second quarter of 2015. The Company's Board of Directors authorized a fourth stock repurchase program in the third quarter of 2015. The timing of the purchases will depend on certain factors, including but not limited to, market conditions and prices, available funds and alternative uses of capital. The stock repurchase program may be carried out through open-market purchases, block trades, negotiated private transactions and pursuant to a trading plan that will be adopted in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934. Repurchased shares are held by the Company as authorized but unissued shares.

The Company repurchased 5,551,053 shares at an average price of \$12.93 under previously approved stock repurchase plans. The Company is authorized to purchase up to 1,285,600 additional shares under the current approved stock repurchase program as of September 30, 2015.

WaterStone Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories. At September 30, 2015, WaterStone Bank exceeded all regulatory capital requirements and is considered "well capitalized" under regulatory guidelines. See "Notes to Consolidated Financial Statements - Regulatory Capital."

The net proceeds from the stock offering significantly increased our liquidity and capital resources. Over time, the initial level of liquidity will be reduced as net proceeds from the stock offering are used for general corporate purposes. Our financial condition and results of operations will be enhanced by the net proceeds from the stock offering, resulting in increased net interest-earning assets and net interest income. However, due to the increase in equity resulting from the net proceeds from the stock offering, our return on assets and return on equity will continue to be adversely affected following the stock offering.

#### Contractual Obligations, Commitments and Contingent Liabilities

The following tables present information indicating various contractual obligations and commitments of the Company as of September 30, 2015 and the respective maturity dates.

|                                       | Total          | One<br>Year<br>or Less | More<br>than<br>One<br>Year<br>Through<br>Three<br>Years | More<br>than<br>Three<br>Years<br>Through<br>Five<br>Years | Over<br>Five<br>Years |
|---------------------------------------|----------------|------------------------|--|--|-----------------------|
|                                       | (In Thousands) |                        |  |  |                       |
| Demand deposits (4)                   | \$96,344       | 96,344                 | -  | -  | -                     |
| Money market and savings deposits (4) | 136,486        | 136,486                | -  | -  | -                     |
| Time deposit (4)                      | 640,325        | 443,190                | 190,162  | 6,973  | -                     |
| Federal Home Loan Bank advances (1)   | 350,000        | 220,000                | 130,000  | -  | -                     |
| Repurchase agreements (2)(4)          | 84,000         | -                      | 84,000   | -  | -                     |
| Operating leases (3)                  | 11,939         | 2,947                  | 4,301  | 2,362  | 2,329                 |
| Salary continuation agreements        | 298            | 170                    | 128  | -  | -                     |
|                                       | \$1,319,392    | 899,137                | 408,591  | 9,335  | 2,329                 |

(1) Secured under a blanket security agreement on qualifying assets, principally, mortgage loans. Excludes interest which will accrue on the advances.

All Federal Home Loan Bank advances with maturities exceeding one year are callable on a quarterly basis.

(2) The repurchase agreements are callable on a quarterly basis until maturity.

(3) Represents non-cancelable operating leases for offices and equipment.

(4) Excludes interest.

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## Off-Balance Sheet Commitments

The following table details the amounts and expected maturities of significant off-balance sheet commitments as of September 30, 2015.

|   | Total          | One<br>Year<br>or Less | More<br>than<br>One<br>Year<br>Through<br>Three<br>Years | More<br>than<br>Three<br>Years<br>Through<br>Five<br>Years | Over<br>Five<br>Years |
|---|----------------|------------------------|--|--|-----------------------|
|   | (In Thousands) |                        |  |  |                       |
| Real estate loan commitments (1)                  | \$34,651       | 34,651                 | -  | -  | -                     |
| Unused portion of home equity lines of credit (2) | 14,509         | 14,509                 | -  | -  | -                     |
| Unused portion of construction loans (3)          | 25,839         | 25,839                 | -  | -  | -                     |
| Unused portion of business lines of credit        | 10,149         | 10,149                 | -  | -  | -                     |
| Standby letters of credit                         | 609            | 609                    | -  | -  | -                     |
| Total Other Commitments                           | \$85,757       | 85,757                 | -  | -  | -                     |

General: Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract and generally have fixed expiration dates or other termination clauses.

(1) Commitments for loans are extended to customers for up to 90 days after which they expire.

(2) Unused portions of home equity loans are available to the borrower for up to 10 years.

(3) Unused portions of construction loans are available to the borrower for up to 1 year.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

#### Management of Market Risk

General. The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits. As a result, a principal part of our business strategy is to manage interest rate risk and reduce the exposure of our net interest income to changes in market interest rates. Accordingly, WaterStone Bank's board of directors has established an Asset/Liability Committee which is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the guidelines approved by the board of directors. Management monitors the level of interest rate risk on a regular basis and the Asset/Liability Committee meets weekly to review our asset/liability policies and interest rate risk position, which are evaluated quarterly.

We have sought to manage our interest rate risk in order to minimize the exposure of our earnings and capital to changes in interest rates. We have implemented the following strategies to manage our interest rate risk: (i) emphasizing variable rate loans including variable rate one- to four-family, and commercial real estate loans as well as three- to five- year commercial real estate balloon loans; (ii) reducing and shortening the expected average life of the investment portfolio; and (iii) whenever possible, lengthening the term structure of our deposit base. These measures should reduce the volatility of our net interest income in different interest rate environments.

Income Simulation. Simulation analysis is an estimate of our interest rate risk exposure at a particular point in time. At least quarterly we review the potential effect changes in interest rates may have on the repayment or repricing of rate sensitive assets and funding requirements of rate sensitive liabilities. Our most recent simulation uses projected repricing of assets and liabilities at September 30, 2015 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rate assumptions may have a significant impact on interest income simulation results. Because of the large percentage of loans and mortgage-backed securities we hold, rising or falling interest rates may have a significant impact on the actual prepayment speeds of our fixed-rate mortgage related assets that may in turn affect our interest rate sensitivity position.

|  | Percentage<br>Increase<br>(Decrease)<br>in<br>Estimated<br>Annual<br>Net<br>Interest<br>Income<br>Over 12<br>Months |   |
|--|---|---|
| 400 basis point gradual rise in rates        | 7.52  | % |
| 300 basis point gradual rise in rates        | 5.98  | % |
| 200 basis point gradual rise in rates        | 4.33  | % |
| 100 basis point gradual rise in rates        | 2.07  | % |
| Unchanged rate scenario                      | 0.00  | % |
| 100 basis point gradual decline in rates (1) | (1.31)  | % |

(1) Given the current low point in the interest rate cycle, rate decline scenarios in excess of 100 basis points are not meaningful.

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WaterStone Bank's Asset/Liability policy limits projected changes in net average annual interest income to a maximum decline of 25% for various levels of interest rate changes measured over a 12-month period when compared to the flat rate scenario. In addition, projected changes in the economic value of equity are limited to a maximum decline of 30% for interest rate movements of up to 400 basis points when compared to the flat rate scenario. These limits are re-evaluated on a periodic basis and may be modified, as appropriate. At September 30, 2015, a 100 basis point gradual increase in interest rates had the effect of increasing forecast net interest income by 2.07% while a 100 basis point decrease in rates had the effect of decreasing net interest income by 1.31%. At September 30, 2015, a 100 basis point gradual increase in interest rates had the effect of decreasing the economic value of equity by 1.75% while a 100 basis point decrease in rates had the effect of increasing the economic value of equity by 1.60%. While we believe the assumptions used are reasonable, there can be no assurance that assumed prepayment rates will approximate actual future mortgage-backed security and loan repayment activity.

Item 4. Controls and Procedures

Disclosure Controls and Procedures: Company management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective.

Internal Control Over Financial Reporting: There have been no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is not involved in any pending legal proceedings as a defendant other than routine legal proceedings occurring in the ordinary course of business. At September 30, 2015, the Company believes that any liability arising from the resolution of any pending legal proceedings will not be material to its financial condition or results of operations.

Item 1A. Risk Factors

There have been no changes in risk factors applicable to the Company from those disclosed in "Risk Factors" in Item 1A of the Company's annual report on Form 10-K for the year ended December 31, 2014.

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

Following are the Company's monthly common stock purchases during the third quarter of 2015:

| Period | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced | Maximum<br>Number of<br>Shares that<br>May<br>Yet Be<br>Purchased<br>Under |
|--------|---|---------------------------------------|--|--|
|        |   |                                       |  |  |



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|  |           |          | Plans     | the Plan <sup>(a)</sup> |
|--|-----------|----------|-----------|-------------------------|
| July 1, 2015 - July 31, 2015           | 698,815   | \$ 13.13 | 698,815   | 432,883                 |
| August 1, 2015 - August 31, 2015       | 246,000   | 12.86    | 246,000   | 186,883                 |
| September 1, 2015 - September 30, 2015 | 329,423   | 12.98    | 329,423   | 1,285,600               |
| Total                                  | 1,274,238 | \$ 13.04 | 1,274,238 | 1,285,600               |

On March 6, 2015, the Board of Directors authorized the repurchase of up to 1,721,170 shares of common stock (Plan 1), of which 1,408,513 shares were purchased. On May 1, 2015, the Board of Directors terminated the existing plan and authorized the repurchase of 2,000,000 shares of common stock (Plan 2), of which, 2,000,000 shares were purchased. On May 12, 2015, the Board of Directors authorized the repurchase of 2,000,000 shares of common stock (Plan 3), of which 1,928,140 were purchased. On September 4, 2015, the Board of Directors terminated the existing plan and authorized the repurchase of 1,500,000 shares of common stock (Plan 4).

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Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

(a) Exhibits: See Exhibit Index, which follows the signature page hereof.

Signatures

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

WATERSTONE FINANCIAL, INC.

(Registrant)

Date: October 30, 2015

/s/ Douglas S. Gordon

Douglas S. Gordon  
Chief Executive Officer  
Principal Executive Officer

Date: October 30, 2015

/s/ Allan R. Hosack

Allan R. Hosack  
Chief Financial Officer  
Principal Financial Officer



EXHIBIT INDEX

WATERSTONE FINANCIAL, INC.

Form 10-Q for Quarter Ended September 30, 2015

| Exhibit<br>No. | Description  | Filed<br>Herewith |
|----------------|--|-------------------|
| 31.1           | <u>Sarbanes-Oxley Act Section 302 Certification signed by the Chief Executive Officer of Waterstone Financial, Inc.</u>  | X                 |
| 31.2           | <u>Sarbanes-Oxley Act Section 302 Certification signed by the Chief Financial Officer of Waterstone Financial, Inc.</u>  | X                 |
| 32.1           | <u>Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer of Waterstone Financial, Inc.</u>   | X                 |
| 32.2           | <u>Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer of Waterstone Financial, Inc.</u>   | X                 |
| 101            | The following financial statements from Waterstone Financial, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2015, formatted in Extensive Business Reporting Language (XBRL): (i) consolidated statements of financial condition, (ii) consolidated statements of income, (iii) consolidated statements of comprehensive income, (iv) consolidated statements of changes in shareholders' equity, (v) consolidated statements of cash flows and (vi) the notes to consolidated financial statements. | X                 |