FS Bancorp, Inc.
Form 10-K
March 27, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark one)

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

For the fiscal year ended December 31, 2014 OR

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

Commission File Number: 001-35589

FS BANCORP, INC.
(Exact name of registrant as specified in its charter)

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

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

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

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

NO [ ]

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

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

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

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

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

As of March 25, 2015, there were 3,235,625 shares of the Registrant's common stock outstanding. The Registrant's common stock is listed on the NASDAQ Capital Market under the symbol "FSBW." The aggregate market value of the common stock held by non-affiliates of the Registrant was $52,293,629, based on the closing sales price of $17.40 per share of the Registrant's common stock as quoted on the NASDAQ Capital Market on June 30, 2014. For purposes of this calculation, common stock held only by executive officers and directors of the Registrant is considered to be held by affiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the definitive Proxy Statement for the 2015 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

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

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Forward Looking Statements

This Form 10-K contains forward looking statements, which can be identified by the use of words such as "believes," "expects," "anticipates," "estimates" or similar expressions. Forward looking statements include:

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

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

- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- secondary market conditions and our ability to sell loans in the secondary market;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market area;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our mortgage banking operations and our warehouse lending and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to control operating costs and expenses;
- changes in consumer spending, borrowing and savings habits;
- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act, changes in regulation policies and principles, or the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our branch expansion strategy;
- inability of key third-party vendors to perform their obligations to us; and
- other economic, competitive, governmental, regulatory and technical factors affecting our operations, pricing, products and services and other risks described elsewhere in this Form 10-K and our other reports filed with the U.S. Securities and Exchange Commission.

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

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the forward-looking statements discussed in this report might not occur and you should not put undue reliance on any forward looking statements.

Available Information

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

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PART 1
Item 1. Business

General
FS Bancorp, Inc. (the “Company”), a Washington corporation, was organized in September 2011 for the purpose of becoming the holding company of 1st Security Bank of Washington (“1st Security Bank of Washington” or the “Bank”) upon the Bank’s conversion from a mutual to a stock savings bank (“Conversion”). The Conversion was completed on July 9, 2012. At December 31, 2014, the Company had consolidated total assets of $509.8 million, total deposits of $420.4 million, and stockholders’ equity of $65.8 million. The Company has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this Annual Report on Form 10-K (“Form 10-K”), including the consolidated financial statements and related data, relates primarily to the Bank.

1st Security Bank of Washington is a relationship-driven community bank. The Bank delivers banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Bank emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Bank is also actively involved in community activities and events within these market areas, which further strengthens relationships within these markets. The Bank has been serving the Puget Sound area since 1936. Originally chartered as a credit union, and known as Washington’s Credit Union, the Bank served various select employment groups. On April 1, 2004, the Bank converted from a credit union to a Washington state-chartered mutual savings bank. Upon completion of the Conversion in July 2012, 1st Security Bank of Washington became a Washington state-chartered stock savings bank and the wholly owned subsidiary of the Company. At December 31, 2014, the Bank maintained seven bank branch locations and five stand-alone loan origination facilities, along with the headquarters.
The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, home loans, commercial real estate mortgage loans, commercial business loans and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans, represent the largest portion of the consumer loan portfolio and have traditionally been the mainstay of the Company’s lending strategy, a carryover from its days as a credit union. Going forward, the Company plans to place more emphasis on certain lending products, such as commercial real estate loans, one-to-four-family loans, commercial business and residential construction loans, while maintaining the current size of the consumer loan portfolio. The Company reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale into the secondary market, through a mortgage banking program. The Company's lending strategies are intended to take advantage of: (1) the Company’s historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities, and (3) relationship lending. Retail deposits will continue to serve as an important funding source. For more information regarding the business and operations of 1st Security Bank of Washington, see Item 7., “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”
1st Security Bank of Washington is examined and regulated by the Washington State Department of Financial Institutions (“DFI”), its primary regulator, and by the Federal Deposit Insurance Corporation (“FDIC”). 1st Security Bank of Washington is required to have certain reserves set by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and is a member of the Federal Home Loan Bank of Seattle (“FHLB” or “FHLB of Seattle”), which is one of the 12 regional banks in the Federal Home Loan Bank System.
The principal executive offices of the Company are located at 6920 220th Street SW, Mountlake Terrace, Washington 98043 and its telephone number is (425) 771-5299.
Market Area

The Company conducts operations out of the main administrative office, five home lending offices, and seven full-service bank branch offices in the Puget Sound region of Washington. The administrative office is located in

Mountlake Terrace, in Snohomish County, Washington. The five stand-alone home lending offices are located in the

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State of Washington in Tri-Cities (Kennewick), in Benton County, Puyallup, in Pierce County, Bellevue, in King County, Bothell, in Snohomish County, and Port Orchard, in Kitsap County. Regarding the seven full-service bank branches, three branch offices are located in Snohomish County, two branch offices are located in King County, one branch office is located in Pierce County to the south, and in Kitsap County to the west.

The primary market area for business operations is the Seattle-Tacoma-Bellevue, WA Metropolitan Statistical Area (the "Seattle MSA"). Kitsap County, though not in the Seattle MSA, is also part of the Company's market area. This overall region is typically known as the "Puget Sound" region. The population of the Puget Sound region was an estimated 3.8 million in 2014, over half of the state's population, representing a large population base for potential business. The region has a well-developed urban area in the western portion along Puget Sound, with the north, central and eastern portions containing a mixture of developed residential and commercial neighborhoods and undeveloped, rural neighborhoods.

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

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

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

Approximately 86.6% of King County households had income levels in excess of $50,000 annually in 2010, compared to 82.5% for the State of Washington and 79.2% for the United States. In 2008, the U.S. Census Bureau determined that Seattle has the highest percentage of college and university graduates of any U.S. city; it was listed as the most literate or second most literate city of the country every year since 2005. Seattle's high income and education levels, especially compared to other major cities, result in King County ranking in the top 100 wealthiest counties in the United States.

Unemployment in Washington was an estimated 6.3% as of December 31, 2014, down from a high of 10.2% in March 2010, closely paralleling national trends. Unemployment rates in Pierce, King, and Snohomish counties have improved in the last 36 months. King County had the lowest unemployment rate in the state at 4.1%, much lower than the state average of 6.3% and national average of 5.6%, respectively. At December 31, 2014, estimated unemployment in Pierce County was 7.2%, down from 7.5% as of December 31, 2013. The estimated unemployment rate in Snohomish County at year end 2014 was 4.5%, down from 5.3% at year end 2013. Kitsap County remained unchanged year over year at a 6.2% unemployment rate as of December 31, 2014. Of the four counties, Snohomish and King counties reflected the largest improvement year over year with unemployment dropping 0.8% in Snohomish

County and 0.6% in King County.
According to the Washington Center for Real Estate Research, home values in the State of Washington continued to improve in 2014. For the quarter ended March 31, 2014, the average home value was $310,000 in Snohomish County, $225,000 in Pierce County, $419,000 in King County, and $232,000 in Kitsap County. Compared

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to the statewide average increase in home values of 8.2% in the first quarter of 2014, Snohomish and King counties have outperformed the state averages, with 15.3% and 13.7% increases, respectively. Kitsap County was up 3.3% year over year, below the state average. Pierce County experienced an 11.3% increase in home values during 2014.
For a discussion regarding the competition in the Company’s primary market area, see “Competition.”

Lending Activities

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

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

	December 31,									
	2014		2013		2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Perce
	(Dollars in thousands)									
Real estate loans										
Commercial	$42,970	10.90 %	$32,970	11.48 %	$33,250	11.88 %	$28,931	13.09 %	$28,061	11.86
Construction and development	57,813	14.67	41,633	14.49	31.893	11.39	10,144	4.59	9,805	4.15
Home equity	15,737	3.99	15,172	5.28	15.474	5.53	14,507	6.56	15,655	6.62
One-to-four-family[(1)]	46,801	11.87	20,809	7.25	13.976	4.99	8,752	3.96	13,218	5.59
Multi-family	16,201	4.11	4,682	1.63	3.202	1.14	1,175	0.53	1,159	0.49
Total real estate loans	179,522	45.54	115,266	40.13	97,795	34.93	63,509	28.73	67,898	28.71
Consumer Loans										
Indirect home improvement	99,304	25.19	91,167	31.74	83,786	29.93	81,143	36.70	94,833	40.10
Solar	18,162	4.61	16,838	5.86	2,463	0.89	—	—	—	—
Marine	16,713	4.24	11,203	3.90	17,226	6.15	23,315	10.55	22,281	9.42
Automobile	674	0.17	1,230	0.43	2,416	0.86	5,832	2.64	12,645	5.35
Recreational	441	0.11	553	0.19	742	0.27	1,156	0.52	1,824	0.77
Home improvement	329	0.08	463	0.16	651	0.23	934	0.42	1,295	0.55
Other	1,184	0.30	1,252	0.44	1,386	0.50	1,826	0.83	2,887	1.21
Total consumer loans	136,807	34.70	122,706	42.72	108,670	38.83	114,206	51.66	135,765	57.40
Commercial business loans	77,881	19.76	49,244	17.15	73,465	26.24	43,337	19.61	32,841	13.89
Total gross loans receivable	394,210	100.00%	287,216	100.00%	279,930	100.00%	221,052	100.00%	236,504	100.0
Less:										
Deferred costs, fees and discounts, net	(946)		(1,043)		(283)		424		223	
Allowance for loan losses	(6,090)		(5,092)		(4,698)		(4,345)		(5,905)	
Total loans receivable, net	$387,174		$281,081		$274,949		$217,131		$230,822	

(1) Excludes loans held for sale.

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

	December 31,									
	2014		2013		2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Perce
	(Dollars in thousands)									
Fixed-rate loans:										
Real estate loans										
Commercial	$23,144	5.87 %	$23,210	8.08 %	$20,947	7.48 %	$17,578	7.95 %	$16,333	6.90
Construction and development	322	0.08	525	0.18	3,958	1.41	3,407	1.54	1,556	0.66
Home equity	2,677	0.68	2,664	0.93	2,557	0.91	2,154	0.97	2,784	1.18
One-to-four-family(1)	8,108	2.06	19,981	6.96	8,328	2.98	5,452	2.47	6,585	2.79
Multi-family	3,240	0.82	3,467	1.21	2,053	0.73	1,175	0.53	1,159	0.49
Total real estate loans	37,491	9.51	49,847	17.36	37,843	13.51	29,766	13.46	28,417	12.02
Consumer	136,368	34.59	122,346	42.60	108,500	38.76	114,201	51.65	135,752	57.39
Commercial business	16,197	4.11	19,792	6.89	16,959	6.06	8,971	4.07	1,049	0.45
Total fixed-rate loans	190,056	48.21	191,985	66.85	163,302	58.33	152,938	69.18	165,218	69.86
Adjustable-rate loans:										
Real estate loans										
Commercial	19,826	5.03	9,760	3.40	12,303	4.40	11,353	5.14	11,728	4.96
Construction and development	57,491	14.58	41,108	14.31	27,935	9.98	6,737	3.05	8,249	3.49
Home equity	13,060	3.31	12,508	4.35	12,917	4.61	12,353	5.59	12,871	5.44
One-to-four-family(1)	38,693	9.82	828	0.29	5,648	2.02	3,300	1.49	6,633	2.80
Multi-family	12,961	3.29	1,215	0.42	1,149	0.41	—	—	—	—
Total real estate loans	142,031	36.03	65,419	22.77	59,952	21.42	33,743	15.27	39,481	16.69
Consumer	439	0.11	360	0.12	170	0.06	5	0.01	13	0.01
Commercial business	61,684	15.65	29,452	10.26	56,506	20.19	34,366	15.54	31,792	13.44
Total adjustable-rate loans	204,154	51.79	95,231	33.15	116,628	41.67	68,114	30.82	71,286	30.14
Total gross loans receivable	394,210	100.00%	287,216	100.00%	279,930	100.00%	221,052	100.00%	236,504	100.0
Less:										
Deferred costs, fees and discounts, net	(946)		(1,043)		(283)		424		223	
Allowance for loan losses	(6,090)		(5,092)		(4,698)		(4,345)		(5,905)	

Total loans receivable, net	$387,174	$281,081	$274,949	$217,131	$230,822

(1) Excludes loans held for sale.

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Loan Maturity. The following table sets forth certain information at December 31, 2014, regarding the dollar amount and current rates of interest for the loans maturing in the portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loan balances do not include undisbursed loan proceeds, unearned discounts, unearned income, and allowance for loan losses.

	Real Estate													
	Commercial		Construction and Development		Home Equity		One-to-Four-Family[2]		Multi-family		Consumer		Commercial Business	
	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	W A R
	(Dollars in thousands)													
Due During Years Ending December 31,														
2015[1]	$1,965	6.60%	$56,069	6.18%	$13,155	4.30%	$1,286	6.38%	$51	6.00%	$1,486	10.75%	$61,364	4
2016	2,082	4.01	1,422	5.96	—	—	763	4.42	—	—	1,650	7.04	44	6
2017	158	4.00	—	—	—	—	869	3.75	398	4.38	3,916	7.52	3,223	3
2018 and 2019	13,403	5.29	322	7.00	—	—	1,820	5.15	3	4.46	10,894	8.69	3,722	5
2020 to 2024	24,549	4.98	—	—	1,267	7.51	2,800	4.63	13,422	4.37	41,866	9.31	8,177	4
2025 to 2029	178	5.00	—	—	—	—	2,303	4.22	2,158	4.89	74,792	7.99	1,351	5
2030 and following	635	6.05	—	—	1,315	7.59	36,960	4.16	169	5.45	2,203	7.41	—	—
Total	$42,970	5.12%	$57,813	6.18%	$15,737	4.84%	$46,801	4.29%	$16,201	4.46%	$136,807	8.44 %	$77,881	4

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

The total amount of loans due after December 31, 2015, which have predetermined interest rates is $178.5 million, while the total amount of loans due after this date which have floating or adjustable interest rates is $80.3 million.

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Lending Authority. The Chief Credit Officer has the authority to approve multiple loans to one borrower up to $6.0 million in aggregate. Loans in excess of $6.0 million require an additional signature from the Chief Executive Officer and/or Chief Financial Officer. All loans that are approved over $2.0 million are reported to the Asset Quality Committee on a monthly basis. The Chief Credit Officer may delegate lending authority to other individuals at levels consistent with their responsibilities.

The Board of Directors has implemented a policy lending limit that it believes matches the Washington State legal lending limit. At December 31, 2014, the Company’s policy limits loans to one borrower and the borrower’s related entities to 20% of the Bank's unimpaired capital and surplus, or $12.4 million at December 31, 2014. Management has adopted a limit of $9.5 million for risk mitigation purposes and all loans over this limit require Board approval. The Company's largest loan or lending relationship at December 31, 2014, consisted of two commercial real estate lines of credit totaling $7.1 million to two limited liability companies. One of these lines had an outstanding balance of $6.2 million secured by 42 rental homes located in Snohomish County, Washington, and the other line had an outstanding balance of $879,000 secured by six rental homes located in Snohomish County, Washington. The second largest loan outstanding consisted of one commercial line of credit to a limited liability company totaling $6.2 million secured by business assets located in Seattle, Washington. The third largest loan to a limited liability company had an outstanding balance of $5.3 million secured by commercial real estate located in Redmond, Washington. All of the foregoing loans were current at December 31, 2014.

At December 31, 2014, the Company had $34.0 million approved in warehouse lending lines for six companies. The commitments ranged from $3.0 million to $9.0 million. As of December 31, 2014, there was $10.1 million in warehouse lines outstanding, compared to $38.0 million approved in warehouse lending lines with $4.0 million outstanding at December 31, 2013.

Commercial Real Estate Lending. The Company offers a variety of commercial real estate loans. Most of these loans are secured by income producing properties, including retail centers, warehouses and office buildings located in the market areas. The Company also has a limited amount of loans secured by multi-family residences. At December 31, 2014, commercial real estate loans (including multi-family residential loans) totaled $59.2 million, or 15.0%, of the gross loan portfolio.

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

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

Loans secured by commercial real estate properties generally involve a greater degree of credit risk than one-to-four-family residential mortgage loans. These loans typically involve large balances to single borrowers or groups of related borrowers. Because payments on loans secured by commercial and multi-family real estate properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower’s ability to repay the loan may be impaired.

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

Construction and Development Lending. The Company expanded its residential construction lending team in 2011 with a focus on vertical, in-city one-to-four-family development. This team has over 60 years of combined experience and expertise in acquisition, development and construction ("ADC") lending in the Puget Sound market area. The Company has implemented this strategy to take advantage of what is believed to be an unmet demand for construction and ADC loans to experienced, successful and relationship driven builders in the market area after many other banks abandoned this segment because of previous overexposure. At December 31, 2014, construction and development loans totaled $57.8 million, or 14.7%, of the gross loan portfolio and consisted of loans for residential and commercial construction projects, primarily for vertical construction. Of the $57.8 million, $3.5 million are land acquisition and development loans.

The Company's residential commercial construction lending program focuses on the origination of loans for the purpose of constructing, on both a pre-sold and speculative basis, and selling primarily one-to-four-family residences within the market area. The Company generally limits these types of loans to known builders and developers in the market area. Construction loans generally provide for the payment of interest only during the construction phase, which is typically up to 12 months. At the end of the construction phase, the construction loan is generally paid off through the sale of the newly constructed home and a permanent loan from another lender, although commitments to convert to a permanent loan may be made by us. Construction loans are generally made with a maximum loan-to-value ratio of the lower of 95% of cost or 75% of appraised value at completion. These loans generally include an interest reserve of 3% to 5.5% of the loan commitment amount.

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

The Company may also make land acquisition and development loans to builders or residential lot developers on a limited basis. These loans involve a higher degree of credit risk, similar to commercial construction loans. At December 31, 2014, included in the $57.8 million of construction loans, were seven residential land acquisition and development loans for finished lots totaling $2.7 million, and one commercial land acquisition and development loan totaling $788,000 with total commitments of $4.4 million. These land loans also involve additional risks because the loan amount is based on the projected value of the lots after development. Loans are made for up to 75% of the estimated value with a term of up to two years. These loans are required to be paid on an accelerated basis as the lots are sold, so that the Company is repaid before all the lots are sold.

Construction financing is generally considered to involve a higher degree of credit risk than longer-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction costs is inaccurate, the Company may be required to advance funds beyond the amount originally committed in order to protect the value of the property. Additionally, if the estimate of value is inaccurate, the Company may be confronted with a project that, when completed, has a value that is insufficient to generate full payment. Land loans also pose additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can also be significantly affected by supply and demand conditions.

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

Home Equity Lending. The Company has been active in second mortgage and home equity lending, with the focus of this lending being conducted in the Company's primary market area. The home equity lines of credit generally have adjustable rates tied to the prime rate of interest with a draw term of ten years and a term to maturity of 15 years. Monthly payments are based on 1.0% of the outstanding balance with a maximum combined loan-to-value ratios of up to 90%, including any underlying first mortgage. Second mortgage home equity loans are typically fixed rate, amortizing loans with terms of up to 15 years. Total second mortgage/home equity loans totaled $15.7 million, or 4.0% of the gross loan portfolio, as of December 31, 2014, $13.1 million of which were adjustable rate home equity lines of credit. Unfunded commitments on loans and lines of credit at December 31, 2014, was $13.7 million.

Residential. The Company originates loans secured by first mortgages on one-to-four-family residences primarily in the market area. The Company originates one-to-four-family residential mortgage loans through referrals from real estate agents, financial planners, builders and from existing customers. Walk-in customers are also an important source of the Company’s loan originations. The Company originated $277.3 million of one-to-four-family mortgages during 2014, of which $263.2 million were sold to investors. Of the loans sold to investors, $135.8 million were sold to Fannie Mae and/or Freddie Mac with servicing rights retained in order to further build the relationship with the customer. At December 31, 2014, one-to-four-family residential mortgage loans totaled $46.8 million, or 11.9%, of the gross loan portfolio, excluding loans held for sale of $26.0 million.

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

Consumer Lending. Consumer lending represents a significant and important historical activity for the Company, primarily reflecting the indirect lending through home improvement contractors and dealers. As of December 31, 2014, consumer loans totaled $136.8 million, or 34.7% of the gross loan portfolio.

The Company’s indirect home improvement loans, also referred to as fixture secured loans, represent the largest portion of the consumer loan portfolio and have traditionally been the mainstay of the Company’s lending strategy. These loans totaled $99.3 million, or 25.2% of total loans, and 72.6% of total consumer loans, at December 31, 2014. Indirect home improvement loans are originated through a network of approximately 132 home improvement contractors and dealers located in Washington, Oregon and California. Three dealers are responsible for a majority or 56.1% of the loan volume. These fixture secured loans consist of loans for a wide variety of products, such as replacement windows, siding, roofs, HVAC systems, and roofing materials.

In order to maintain the Company's indirect home improvement loan volume, the Company expanded into the State of California in 2012 with a limited number of contractors and dealers of solar loans. Solar loans are the second largest portion of the consumer loan portfolio. As of December 31, 2014, the Company had $17.7 million in loans to borrowers that reside in California, or 4.5% of total loans, and 13.0% of total consumer loans. The Company's primary home improvement focus in California is on consumer solar panel installations which comprise 100% of the volume originated in California.

In connection with fixture secured loans, the Company receives loan applications from the dealers, and originates the loans based on pre-defined lending criteria. The loans are processed through the loan origination software, with approximately 40% of the loan applications receiving an automated approval based on the information provided, and the remaining loans processed by the Company’s credit analysts. The Company follows the internal underwriting guidelines in evaluating loans obtained through the indirect dealer program, including using FICO credit scores to

approve loans.
The Company’s fixture secured loans generally range in amounts from $2,500 to $50,000, and generally carry terms of up to 15 years with fixed rates of interest. In some instances, the participating dealer may pay a fee to buy down the borrower's interest rate to a rate below the Company's published rate. Fixture secured loans are secured by

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the personal property installed in, on or at the borrower's real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower's residence. The Company generally files a UCC-2 financing statement to perfect the security interest in the personal property in situations where the borrower's credit score is below 720 or the home improvement loan is for an amount in excess of $10,000. Perfection gives the Company a claim to the collateral that is superior to someone that obtains a lien through the judicial process subsequent to the perfection of a security interest. The failure to perfect a security interest does not render the security interest unenforceable against the borrower. However, failure to perfect a security interest risks avoidance of the security interest in bankruptcy or subordination to the claims of third parties.

The Company also offers consumer marine loans, secured by boats. Marine loans represent the third largest segment of the consumer loan portfolio. As of December 31, 2014, the marine loan portfolio totaled $16.7 million, or 4.2% of total loans and 12.2% of total consumer loans. Marine loans are originated with borrowers on both a direct and indirect basis and carry terms of up to 20 years, and generally have fixed rates of interest. The Company requires a 10% down payment, and the loan amount may be up to the lesser of 120% of factory invoice or 90% of the purchase price.

The Company sold 288 consumer solar loans with an aggregate principal balance of approximately $9.1 million during 2014 to reduce interest rate risk and recognize a gain on the sale of the loans. The loans had 12 year fixed amortization schedules and an average interest rate of 9.99%. Loans were sold without recourse.

Historically, automobile loans represented a lending focus whereby indirect loans were originated through a dealer network throughout the northwest region of the United States for new and used cars. In recent years, however, the Company has made automobile loan originations available only through its branch office locations which resulted in a steady decline in the size of the automobile loan portfolio yet enabled us to establish stronger borrower relationships. The balance of automobile loans totaled $674,000, or 0.2% of the gross loan portfolio, at December 31, 2014. Automobile loans currently originated by the branches may be written for up to seven years for a new or used car with fixed rates of interest. The Company also originates a small number of other consumer loans, including direct home improvement, loans on deposit, recreational and other consumer loans, which totaled $2.0 million as of December 31, 2014. These loans generally carry fixed as well and terms up to five years.

In evaluating any consumer loan application, a borrower's FICO score is utilized as an important indicator of credit risk. The FICO score represents the creditworthiness of a borrower based on the borrower's credit history, as reported by an independent third party. A higher FICO score indicates a greater degree of creditworthiness. Over the last several years the Company has emphasized originations of loans to consumers with higher credit scores. This has resulted in a lower level of loan charge-offs in recent periods. As of December 31, 2014, 69.5% of the consumer loan portfolio was originated with borrowers having a FICO score over 720 at the time of origination, and 95.9% was originated with borrowers having a FICO score over 660 at the time of origination. Consideration for loans with FICO scores below 640 require additional management oversight and approval.

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

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

Company generally will be able to collect.

Commercial Business Lending. The Company originates commercial business loans and lines of credit to local small- and mid-sized businesses in the Puget Sound market area that are secured by accounts receivable, inventory or property, plant and equipment. Consistent with management's objectives to expand commercial business lending,

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in 2009, the Company commenced a mortgage warehouse lending program through which the Company funds third party mortgage bankers. Under this program the Company provides short term funding to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. The Company's warehouse lending lines are secured by the underlying notes associated with mortgage loans made to borrowers by the mortgage banking company and generally require guarantees from the principle shareholder(s) of the mortgage banking company. These loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down the outstanding loan before being dispersed to the mortgage bank. At December 31, 2014, the Company had approved warehouse lending lines for six companies with varying limits from $3.0 million up to $9.0 million for an aggregate amount of $34.0 million. During the year ended December 31, 2014, the Company processed approximately 1,000 loans and funded approximately $272.1 million under this program, with $10.1 million outstanding at December 31, 2014.

Commercial business loans may be fixed-rate, but are usually adjustable-rate loans indexed to the prime rate of interest, plus a margin. Some of the commercial business loans, such as those made pursuant to the warehouse lending program, are structured as lines of credit with terms of 12 months and interest only payments required during the term, while other loans may reprice on an annual basis and amortize over a two to five year period. Due to the current interest rate environment, these loans and lines of credit are generally originated with a floor, which is generally set between 4.5% and 5.5%. Loan fees are generally charged at origination depending on the credit quality and account relationships of the borrower. Advance rates on these types of lines are generally limited to 80% of accounts receivable and 50% of inventory. The Company also generally requires the borrower to establish a deposit relationship as part of the loan approval process. At December 31, 2014, the commercial business loan portfolio totaled $77.9 million, or 19.8%, of the gross loan portfolio including warehouse lending loans.

At December 31, 2014, most of the commercial business loans were secured. The Company's commercial business lending policy includes credit file documentation and analysis of the borrower's background, capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as an evaluation of other conditions affecting the borrower. Analysis of the borrower's past, present and future cash flows is also an important aspect of credit analysis. The Company generally requires personal guarantees on commercial business loans. Nonetheless, commercial business loans are believed to carry higher credit risk than residential mortgage loans. The largest two commercial business lending relationships consisted of one line of credit per borrower, each having commitments of $9.0 million. The first to a single borrower consisting of a warehouse line of credit secured by the underlying notes associated with mortgage loans, of which $380,000 was outstanding at December 31, 2014. The other line was to a single borrower consisting of a line of credit secured by accounts receivable, of which $6.2 million was outstanding at December 31, 2014.

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

Loan Originations, Servicing, Purchases and Sales

The Company originates both fixed-rate and adjustable-rate loans. The ability to originate loans, however, is dependent upon customer demand for loans in the market areas. Over the past few years, the Company has continued to originate consumer loans, and increased emphasis on commercial real estate and commercial business lending, and to a lesser extent construction and development lending. Demand is affected by competition and the interest rate environment. In periods of economic uncertainty, the ability of financial institutions, including us, to originate large dollar volumes of commercial business and real estate loans may be substantially reduced or restricted, with a resultant decrease in interest income.

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In addition to interest earned on loans and loan origination fees, the Company receives fees for loan commitments, late payments and other miscellaneous services. The fees vary from time to time, generally depending on the supply of funds and other competitive conditions in the market.

The Company will sell long-term, fixed-rate residential real estate loans in the secondary market to mitigate interest rate risk. These loans are generally sold for cash in amounts equal to the unpaid principal amount of the loans determined using present value yields to the buyer. These sales allowed for a servicing fee on loans when the servicing is retained by the Company. Most residential real estate loans sold by the Company were sold with servicing retained. The Company earned gross mortgage servicing fees of $678,000 for the year ended December 31, 2014. At December 31, 2014, the Company was servicing a $340.2 million one-to-four-family portfolio. Those servicing rights constituted a $3.1 million asset on the books on that date, which is amortized in proportion to and over the period of the net servicing income. These mortgage servicing rights are periodically evaluated for impairment based on their fair value, which takes into account the rates and potential prepayments of those sold loans being serviced. The fair value of the servicing rights at December 31, 2014 was $3.1 million. See Notes 4 and 14 of the Notes to Consolidated Financial Statements included in Item 8., “Financial Statements and Supplementary Data” of this Form 10-K.

The following table presents the activity during the year ended December 31, 2014, related to loans serviced for others.

Beginning balance at December 31, 2013	(In thousands)	
One-to-four-family	$235,718	
Consumer	4,737	
Commercial	2,579	
Subtotal	243,034	
Additions		
One-to-four-family	131,714	
Subtotal	131,714	
Repayments		
One-to-four-family	(27,189	)
Consumer	(1,658	)
Commercial	(45	)
Subtotal	(28,892	)
Ending balance at December 31, 2014		
One-to-four-family	340,243	
Consumer	3,079	
Commercial	2,534	
Total	$345,856	

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

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

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

	Years Ended December 31,	
	2014	2013
	(In thousands)	
Originations by type:		
Fixed-rate:		
Commercial	$5,442	$7,866
Home equity	810	810
One-to-four-family [1]	9,186	2,607
Loans held for sale [2]	277,334	242,036
Multi-family	948	2,364
Consumer	66,976	59,750
Commercial business (excluding warehouse lines)	8,204	5,714
Total fixed-rate	368,900	321,147
Adjustable- rate:		
Commercial	14,169	7,881
Construction and development	103,917	74,519
Home equity	7,854	4,755
One-to-four-family [1]	43,621	7,667
Multi-family	11,916	550
Consumer	415	389
Commercial business (excluding warehouse lines)	56,806	33,085
Warehouse lines, net	6,082	(34,944)
Total adjustable-rate	244,780	93,902
Total loans originated	613,680	415,049
Sales and repayments:		
Commercial	3,250	2,609
Loans held for sale	263,229	239,642
Consumer	21,995	14,485
Total loans sold	288,474	256,736
Total principal repayments	206,393	148,633
Total reductions	494,867	405,369
Net increase (decrease)	$118,813	$9,680

(1) One-to-four-family portfolio loans.
(2) One-to-four-family held for sale loans are included as fixed rate originations.

Asset Quality

When a borrower fails to make a required payment on a residential real estate loan, the Company attempts to cure the delinquency by contacting the borrower. In the case of loans secured by residential real estate, a late notice typically is sent 16 days after the due date, and the borrower is contacted by phone within 16 to 25 days after the due date. When the loan is 30 days past due, an action plan is formulated for the credit under the direction of the Manager of the Loan Control department. Generally, a delinquency letter is mailed to the borrower. All delinquent accounts are reviewed by a loan control representative who attempts to cure the delinquency by contacting the borrower once the loan is 30 days past due. If the account becomes 60 days delinquent and an acceptable repayment plan has not been agreed upon, a loan control representative will generally refer the account to legal counsel with instructions to prepare a notice of intent to foreclose. The notice of intent to foreclose allows the borrower up to 30 days to bring the account

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current. Between 90 - 120 days past due, a value is obtained for the loan collateral. At that time, a mortgage analysis is completed to determine the loan-to-value ratio and any collateral deficiency. If foreclosed, the Company customarily takes title to the property and sells it directly through a real estate broker.

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

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

The following table shows delinquent loans by the type of loan and number of days delinquent as of December 31, 2014.

	Loans Delinquent For:								
	60-89 Days			Non-Accrual 90 Days and Over			Total Loans Delinquent 60 Days or More		
	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category
	(Dollars in thousands)								
Real estate loans									
Commercial	—	$—	— %	—	$—	— %	—	$—	— %
Construction and development	—	—	—	—	—	—	—	—	—
Home equity	5	196	1.25	1	61	0.39	6	257	1.64
One-to-four-family	—	—	—	1	73	0.16	1	73	0.16
Multi-family	—	—	—	—	—	—	—	—	—
Total real estate loans	5	196	0.11	2	134	0.07	7	330	0.18
Consumer									
Indirect home improvement	33	277	0.28	26	250	0.25	59	527	0.53
Solar	—	—	—	1	29	0.16	1	29	0.16
Marine	—	—	—	1	19	0.11	1	19	0.11
Automobile	—	—	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—	—	—
Home improvement	1	6	1.82	—	—	—	1	6	1.82
Other	1	14	1.18	1	1	0.09	2	15	1.27
Total consumer loans	35	297	0.22	29	299	0.22	64	596	0.44
Commercial business loans	—	—	—	—	—	—	—	—	—
Total	40	$493	0.13 %	31	$433	0.11 %	71	$926	0.24 %

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

	December 31,				
	2014	2013	2012	2011	2010
Non-accruing loans:	(Dollars in thousands)				
Real estate loans					
Commercial	$—	$567	$783	$—	$1,201
Construction and development	—	—	—	623	2,175
Home equity	61	172	248	267	574
One-to-four-family	73	104	344	412	211
Total real estate loans	134	843	1,375	1,302	4,161
Consumer loans					
Indirect home improvement	250	258	295	454	522
Solar	29	—	—	—	—
Marine	19	—	—	—	—
Automobile	—	—	10	23	54
Recreational	—	—	—	1	38
Home improvement	—	—	32	—	75
Other	1	—	—	20	3
Total consumer loans	299	258	337	498	692
Commercial business loans	—	—	194	427	1,387
Total non-accruing loans	433	1,101	1,906	2,227	6,240
Accruing loans delinquent more than 90 days:					
Home equity	—	—	—	—	62
Total accruing loans delinquent more than 90 days	—	—	—	—	62
Real estate owned	—	2,075	2,127	4,589	3,701
Repossessed consumer property	—	32	31	78	78
Total non-performing assets	$433	$3,208	$4,064	$6,894	$10,081
Restructured loans	$783	$815	$3,260	$3,249	$1,508
Total non-performing assets as a percentage of total assets	0.08 %	0.77 %	1.13 %	2.43 %	3.45 %

For the year ended December 31, 2014, gross interest income which would have been recorded had the non-accruing loans been current in accordance with their original terms was $12,800. The amount of interest income on these non-accrual loans that was included in net income was $26,600.

Real Estate Owned. Real estate acquired by the Company as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate owned until it is sold. When the property is acquired, it is recorded at the lower of its cost, which is the unpaid principal balance of the related loan plus foreclosure costs, or the fair market value of the property less selling costs. The Company had no real estate owned properties as of December 31, 2014.

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Restructured Loans. According to generally accepted accounting principles ("GAAP"), the Company is required to account for certain loan modifications or restructuring as a “troubled debt restructuring.” In general, the modification or restructuring of a debt is considered a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower’s financial difficulties, grants a concession to the borrowers that would not otherwise be considered. The Company had four restructured loans as of December 31, 2014, totaling $783,000, all of which performed as agreed for over six months and are classified as accrual loans. There were no non-accrual restructured loans at December 31, 2014.

Other Assets Especially Mentioned. At December 31, 2014, there were five loans totaling $6.8 million with respect to which known information about the possible credit problems of the borrowers have caused management to have doubts as to the ability of the borrowers to comply with present loan repayment terms and which may result in the future inclusion of such items in the non-performing asset categories.

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

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

In connection with the filing of periodic reports with the FDIC and in accordance with the Company’s classification of assets policy, the Company regularly reviews the problem assets in the portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of the review of the Company’s assets, as of December 31, 2014, the Company had classified $2.2 million of assets as substandard. The $2.2 million of classified assets represented 3.4% of equity and 0.4% of total assets as of December 31, 2014. At December 31, 2014, the Company had classified $6.8 million of assets as special mention.

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Allowance for Loan Losses

The Company maintains an allowance for loan losses to absorb probable incurred credit losses in the loan portfolio. The allowance is based on ongoing, monthly assessments of the estimated probable incurred losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers the types of loans and the amount of loans in the loan portfolio, peer group information, historical loss experience, adverse situations that may affect the borrower’s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. Large groups of smaller balance homogeneous loans, such as residential real estate, small commercial real estate, home equity and consumer loans, are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions. More complex loans, such as commercial real estate loans and commercial business loans, are evaluated individually for impairment, primarily through the evaluation of net operating income and available cash flow and their possible impact on collateral values.

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

The provision for loan losses was $1.8 million for the year ended December 31, 2014. The allowance for loan losses was $6.1 million, or 1.5% of total loans at December 31, 2014, as compared to $5.1 million, or 1.8% of total loans outstanding at December 31, 2013. The level of the allowance is based on estimates, and the ultimate losses may vary from the estimates. Management will continue to review the adequacy of the allowance for loan losses and make adjustments to the provision for loan losses based on loan growth, economic conditions, charge-offs and portfolio composition.

Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, reflects probable incurred loan losses in the loan portfolio. See Notes 1 and 3 of the Notes to Consolidated Financial Statements included in Item 8., “Financial Statements and Supplementary Data” of this Form 10-K.

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

	December 31, 2014		2013		2012		2011		2010	
	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans
	(Dollars in thousands)									
Allocated at end of year to (1):										
Real estate loans										
Commercial	$734	10.90 %	$471	11.48 %	$247	11.88 %	$218	13.09 %	$246	11.86 %
Construction and development	910	14.67	709	14.49	557	11.39	206	4.59	670	4.15
Home equity	251	3.99	656	5.28	598	5.53	242	6.56	265	6.62
One-to-four-family	493	11.87	395	7.25	277	4.99	181	3.96	170	5.59
Multi-family	208	4.11	60	1.63	21	1.14	9	0.53	5	0.49
Total real estate loans	2,596	45.54	2,291	40.13	1,700	34.93	856	28.73	1,356	28.71
Consumer loans										
Indirect home improvement	1,550	25.19	1,457	31.74	1,809	29.93	2,205	36.70	2,580	40.10
Solar	211	4.61	243	5.86	53	0.89	—	—	—	—
Marine	177	4.24	118	3.90	237	6.15	393	10.55	503	9.42
Automobile	6	0.17	14	0.43	31	0.86	279	2.64	405	5.35
Recreational	7	0.11	9	0.19	10	0.27	19	0.52	41	0.77
Home improvement	9	0.08	5	0.16	17	0.23	20	0.42	47	0.55
Other	28	0.30	15	0.44	21	0.50	38	0.83	68	1.21
Total consumer loans	1,988	34.70	1,861	42.72	2,178	38.83	2,954	51.66	3,644	57.40
Commercial business loans	1,506	19.76	940	17.15	820	26.24	535	19.61	905	13.89
Total	$6,090	100.00 %	$5,092	100.00 %	$4,698	100.00 %	$4,345	100.00 %	$5,905	100.00 %

(1) Unallocated allowance for loan losses has been allocated to the appropriate loan categories based on a percentage of the loan receivables balance for that category.

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Management believes that it uses the best estimate information available to determine the allowance for loan losses. However, unforeseen market conditions could result in adjustments to the allowance for loan losses and net income could be significantly affected, if circumstances differ substantially from the assumptions used in determining the allowance. The following table sets forth an analysis of the allowance for loan losses at the dates and or the periods indicated.

	Years Ended December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Balance at beginning of year	$5,092	$4,698	$4,345	$5,905	$7,405
Charge-offs:					
Real estate loans					
Commercial	120	340	48	152	—
Construction and development	—	194	94	38	1,529
Home equity	94	257	381	435	163
One-to-four-family	—	18	257	11	32
Total real estate loans	214	809	780	636	1,724
Consumer loans					
Indirect home improvement	1,341	1,562	2,156	2,497	2,490
Solar	—	—	—	—	—
Marine	15	43	—	—	—
Automobile	18	46	137	507	637
Recreational	12	45	203	372	413
Home improvement	—	32	0	52	76
Other	21	29	85	91	178
Total consumer loans	1,407	1,757	2,581	3,519	3,794
Commercial business loans	75	63	179	684	175
Total charge-offs	1,696	2,629	3,540	4,839	5,693
Recoveries:					
Real estate loans					
Commercial	—	38	—	—	—
Home equity	80	35	9	30	—
One-to-four-family	104	18	—	—	—
Total real estate loans	184	91	9	30	—
Consumer loans					
Indirect home improvement	630	510	630	528	351
Solar	—	—	—	—	—
Marine	13	17	—	—	—
Automobile	43	98	171	252	275
Recreational	6	99	107	52	70
Home improvement	8	3	8	14	0
Other	8	19	36	34	17
Total consumer loans	708	746	952	880	713
Commercial business loans	2	16	19	—	—
Total recoveries	894	853	980	910	713

Net charge-offs	802	1,776	2,560	3,929	4,980
Additions charged to operations	1,800	2,170	2,913	2,369	3,480
Balance at end of year	$6,090	$5,092	$4,698	$4,345	$5,905
Net charge-offs during the year to average loans outstanding during the year	0.24 %	0.63 %	1.03 %	1.81 %	2.11 %
Net charge-offs during the year to average non-performing assets	44.04 %	48.84 %	46.72 %	0.51 %	47.40 %
Allowance as a percentage of non-performing loans	1,406.47 %	462.49 %	246.48 %	195.11 %	93.70 %
Allowance as a percentage of gross loans receivable (end of year)	1.54 %	1.77 %	1.68 %	1.97 %	2.50 %

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Investment Activities

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

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

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

As a member of the FHLB of Seattle, the Bank had $1.7 million in stock of the FHLB of Seattle at December 31, 2014. For the year ended December 31, 2014, the Bank received $2,000 in dividends from the FHLB of Seattle. During 2014, the FHLB of Seattle repurchased approximately $276,000 in excess stock at par from the Bank, resulting in a reduction in the balance of stock held at the Bank.

The table below sets forth information regarding the composition of the securities portfolio and other investments at the dates indicated. At December 31, 2014, the securities portfolio did not contain securities of any issuer with an aggregate book value in excess of 10% of equity capital, excluding those issued by the United States Government or its agencies.

	December 31,					
	2014		2013		2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)					
Securities available-for-sale						
Federal agency securities	$5,998	$5,845	$12,297	$11,667	$12,287	$12,552
Municipal bonds	15,886	16,161	13,347	13,180	8,863	9,060
Corporate securities	4,495	4,437	4,005	3,938	2,492	2,488
Mortgage-backed securities	20,169	20,244	27,952	27,454	18,766	19,213
Small business administration securities	2,019	2,057	—	—	—	—
Total securities available-for-sale	48,567	48,744	57,601	56,239	42,408	43,313

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The composition and contractual maturities of the investment portfolio at December 31 2014, excluding FHLB stock, are indicated in the following table. The yields on municipal bonds have not been computed on a tax equivalent basis.

	December 31, 2014										
	1 year or less		Over 1 year to 5 years		Over 5 to 10 years		Over 10 years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Fair Value
	(Dollars in thousands)										
Securities available-for-sale											
Federal agency securities	$502	1.45 %	$500	1.25 %	$4,996	2.06 %	$—	— %	$5,998	1.94 %	$5,845
Municipal bonds	—	—	4,847	2.05	4,182	2.42	6,857	2.73	15,886	2.44	16,161
Corporate securities	1,001	0.84	500	0.49	2,994	1.43	—	—	4,495	1.19	4,437
Mortgage-backed securities	—	—	—	—	3,000	1.56	17,169	2.20	20,169	2.11	20,244
Small business administration securities	—	—	—	—	2,019	2.90	—	—	2,019	2.90	2,057
Total securities available-for-sale	$1,503	1.04 %	$5,847	1.85 %	$17,191	2.05 %	$24,026	2.36 %	$48,567	2.15 %	$48,744

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Deposit Activities and Other Sources of Funds

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

The Company's deposit composition reflects a mixture with certificates of deposit accounting for approximately 38.0% of the total deposits at December 31, 2014, and interest and noninterest-bearing checking, savings and money market accounts comprising the balance of total deposits. The Company relies on marketing activities, convenience, customer service and the availability of a broad range of deposit products and services to attract and retain customer deposits. The Company also had $19.1 million of brokered deposits at December 31, 2014, with original terms averaging four years which were used to manage interest rate risk.

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

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

	Years Ended December 31,		
	2014	2013	2012
	(Dollars in thousands)		
Beginning balance	$336,876	$288,949	$246,418
Net deposits before interest credited	81,134	45,949	40,323
Interest credited	2,434	1,978	2,208
Ending balance	$420,444	$336,876	$288,949
Net increase in deposits	$83,568	$47,927	$42,531
Percent increase	24.81 %	16.59 %	17.26 %

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

	December 31,					
	2014			2013		
	Amount	Percent of Total		Amount	Percent of Total	
	(Dollars in thousands)					
Transactions and Savings Deposits						
Noninterest-bearing checking	$53,743	12.78	%	$44,309	13.15	%
Interest-bearing checking	29,585	7.04		26,725	7.93	
Savings	21,560	5.13		15,345	4.56	
Money market	152,611	36.30		119,162	35.37	
Escrows	2,991	0.71		1,474	0.44	
Total transaction and savings deposits	260,490	61.96		207,015	61.45	
Certificates						
0.00 – 1.99%	145,099	34.51		113,193	33.60	
2.00 – 3.99%	14,855	3.53		16,479	4.89	
4.00 – 5.99%	—	—		189	0.06	
Total certificates	159,954	38.04		129,861	38.55	
Total deposits	$420,444	100.00	%	$336,876	100.00	%

The following table sets forth the rate and maturity information of time deposit certificates at December 31, 2014.

	0.00-1.99%		2.00-3.99%		4.00-5.99%		Total		Percent of Total	
	(Dollars in thousands)									
Certificate accounts maturing in quarter ending:										
March 31, 2015	$11,240		$316		$—		$11,556		7.22	%
June 30, 2015	15,860		1,474		—		17,334		10.84	
September 30, 2015	2,635		6,510		—		9,145		5.72	
December 31, 2015	9,785		5,913		—		15,698		9.81	
March 31, 2016	14,080		215		—		14,295		8.94	
June 30, 2016	37,667		129		—		37,796		23.63	
September 30, 2016	3,729		198		—		3,927		2.46	
December 31, 2016	3,218		100		—		3,318		2.07	
March 31, 2017	2,032		—		—		2,032		1.27	
June 30, 2017	23,786		—		—		23,786		14.87	
September 30, 2017	3,304		—		—		3,304		2.07	
December 31, 2017	7,940		—		—		7,940		4.96	
Thereafter	9,823		—		—		9,823		6.14	
Total	$145,099		$14,855		$—		$159,954		100.00	%
Percent of total	90.71	%	9.29	%	—	%	100.00	%		

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The following table indicates the amount of jumbo certificates of deposit by time remaining until maturity as of December 31, 2014. Jumbo certificates of deposit are certificates in amounts of $100,000 or more.

	Maturity				
	3 Months or Less	Over 3 to 6 Months	Over 6 to 12 Months	Over 12 Months	Total
	(In thousands)				
Certificates of deposits of less than $100,000[(1)]	$5,919	$4,841	$6,623	$34,940	$52,323
Certificates of deposits of $100,000 through $250,000	1,393	7,904	12,325	52,386	74,008
Certificates of deposits of more than $250,000	4,244	4,589	5,895	18,895	33,623
Total certificates of deposit	$11,556	$17,334	$24,843	$106,221	$159,954

(1): Includes $19.1 million of brokered deposits as of December 31, 2014.

The Federal Reserve requires the Bank to maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the Federal Reserve Bank of San Francisco. Negotiable order of withdrawal (NOW) accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to the reserve requirements, as are any non-personal time deposits at a savings bank. As of December 31, 2014, the Bank’s deposit with the Federal Reserve Bank of San Francisco and vault cash exceeded the reserve requirements.

Borrowings. Although customer deposits are the primary source of funds for lending and investment activities, the Company does use advances from the FHLB of Seattle, and to a lesser extent federal funds purchased to supplement the supply of lendable funds, to meet short-term deposit withdrawal requirements and also to provide longer term funding to better match the duration of selected loan and investment maturities.

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

As a member of the FHLB of Seattle, the Bank is required to own capital stock in the FHLB of Seattle and authorized to apply for advances on the security of that stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the U.S. Government) provided certain creditworthiness standards have been met. Advances are individually made under various terms pursuant to several different credit programs, each with its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. The Bank maintains a committed credit facility with the FHLB of Seattle that provides for immediately available advances up to an aggregate of $57.6 million. At December 31, 2014, outstanding advances from the FHLB of Seattle totaled $17.0 million. At December 31, 2014, the Bank had $69.6 million additional short-term borrowing capacity with the Federal Reserve Bank. The Bank also had an aggregate of $35.0 million in unsecured Fed Funds lines of credit with other large financial institutions of which none was outstanding at December 31, 2014.

The Company had a $5.0 million collateralized warehouse line of credit with another bank, of which none was outstanding at December 31, 2014.

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The following tables set forth information regarding borrowings during the years indicated. The tables include both long- and short-term borrowings.

	Years Ended December 31,					
	2014		2013		2012	
Maximum balance:	(Dollars in thousands)					
Federal Home Loan Bank advances	$47,522		$28,664		$21,840	
Federal Reserve Bank	$1,000		$—		$—	
Fed Funds lines of credit	$3,450		$1,850		$2,000	
Average balances:						
Federal Home Loan Bank advances	$22,589		$16,391		$7,636	
Federal Reserve Bank	$33		$—		$—	
Fed Funds lines of credit	$72		$18		$6	
Weighted average interest rate:						
Federal Home Loan Bank advances	1.23	%	0.85	%	0.91	%
Federal Reserve Bank	0.75	%	—	%	—	%
Fed Funds lines of credit	0.25	%	1.16	%	1.10	%

	At December 31,					
	2014		2013		2012	
Balance outstanding at end of year:	(Dollars in thousands)					
Federal Home Loan Bank advances	$17,034		$16,664		$6,840	
Total borrowings	$17,034		$16,664		$6,840	
Weighted average interest rate of:						
Federal Home Loan Bank advances, at end of period	1.35	%	1.41	%	1.96	%

Subsidiary and Other Activities

The Company has one active subsidiary, the Bank, and the Bank has one inactive subsidiary. The Bank had no capital investment in its inactive subsidiary as of December 31, 2014.

Competition

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

The market area has a high concentration of financial institutions, many of which are branches of large money centers and regional banks that have resulted from the consolidation of the banking industry in Washington and other western states. These include such large national lenders as Wells Fargo, Bank of America, Chase and others in the Company’s market area that have greater resources and offer services that the Bank does not provide. For example,

the Bank does not offer trust services. Customers who seek "one-stop shopping" may be drawn to institutions that offer services that the Bank does not.

The Company attracts deposits through the branch office system. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds and other alternative investments. The Bank competes for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on the most recent branch deposit data provided by the FDIC, as of June 30, 2014, 1st Security Bank of Washington's share of aggregate deposits in the market area consisting of the four counties where the Company has branches was less than one percent.

Employees

At December 31, 2014, the Company had 208 full-time employees and two part-time employees. Company employees are not represented by any collective bargaining group. The Company considers employee relations to be good.

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

Name	Age (1)	Position Company	Bank
Joseph C. Adams	55	Director and Chief Executive Officer	Director and Chief Executive Officer
Matthew D. Mullet	36	Chief Financial Officer, Treasurer and Secretary	Chief Financial Officer
Robert B. Fuller	55	Chief Credit Officer	Chief Credit Officer
Dennis V. O'Leary	47	—	Chief Lending Officer
Drew B. Ness	50	—	Chief Operating Officer

(1) As of December 31, 2014.

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

Joseph C. Adams, age 55, is a director and has been the Chief Executive Officer of 1st Security Bank of Washington since July 2004. He joined 1st Security Bank of Washington in April 2003 as its Chief Financial Officer, when the Bank was Washington's Credit Union. Mr. Adams also served as Supervisory Committee Chairperson from 1993 to 1999. Mr. Adams is a lawyer having worked for Deloitte as a tax consultant, K&L Gates as a lawyer and then at Univar USA as a lawyer and Director, Regulatory Affairs. Mr. Adams received a Masters Degree equivalent from the Pacific Coast Banking School. Mr. Adams' legal and accounting backgrounds, as well as his duties as Chief Executive Officer of 1st Security Bank of Washington, bring a special knowledge of the financial, economic and regulatory challenges faced by the Bank which makes him well suited to educate the Board on these matters.

Matthew D. Mullet, age 36, joined 1st Security Bank of Washington in July 2011 and was appointed Chief Financial Officer in September 2011. Mr. Mullet started his banking career in June 2000 as a financial examiner with the Washington State Department of Financial Institutions, Division of Banks, where he worked until October 2004. From October 2004 until August 2010, Mr. Mullet was employed at Golf Savings Bank, Mountlake Terrace, WA, where he served in several financial capacities, including as Chief Financial Officer from May 2007 until August 2010. In

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

Robert B. Fuller, age 55, joined 1st Security Bank of Washington as Chief Credit Officer in September of 2013. Prior to his employment with the Bank, Mr. Fuller served as Chief Financial Officer/Chief Credit Officer for Blueprint Capital, REIT in 2013, Chief Credit Officer for Core Business Bank during 2012 and Plaza Bank during 2011, and in credit administration at Golf Savings Bank/Sterling Bank during 2009 and 2010. Mr. Fuller also served as Executive Vice President, Chief Operating Officer, and Chief Financial Officer for Golf Savings Bank from March 2001 to September 2006 and was a member of the integration team for the Golf sale to Sterling Savings Bank. Mr. Fuller started his banking career at US Bank of Washington’s mid-market production team and has over 28 years of banking experience.

Dennis V. O’Leary, age 47, joined 1st Security Bank of Washington as Senior Vice President – Consumer, Small Business and Construction Lending in August 2011 and currently holds the position of Chief Lending Officer. Prior to his employment with the Bank, Mr. O’Leary previously was employed by Sterling Savings Bank from July 2006 until August 2011 as Senior Vice President and Puget Sound Regional Director of the residential construction lending division. Sterling Savings Bank acquired Golf Savings Bank in 2006 where Mr. O’Leary had served as Executive Vice President, Commercial Real Estate Lending, having previously served in various senior lending positions at Golf Savings Bank since June 1985.

Drew B. Ness, age 50, joined 1st Security Bank of Washington as Chief Operating Officer in September 2008. Mr. Ness has 24 years of diverse banking experience, including retail branch sales and service, branch network management, and national customer service training experience. He served as Vice President and Manager of the Corporate Deposit Operations Department for Washington Federal, Seattle, Washington from February 2008 until August 2008, following its acquisition of First Mutual Bank. Mr. Ness served as Vice President and Administrative/Operations Manager of the Retail Banking Group at First Mutual Bank, Bellevue, Washington from June 2004 through February 2008, and in various management positions for Bank of America in Seattle, Washington and Newport Beach, California prior to that.

HOW WE ARE REGULATED

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

The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act"). Among other changes, the Dodd-Frank Act established the CFPB as an independent bureau of the Federal Reserve Board. The CFPB assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. However, institutions of less than $10 billion in assets, such as 1st Security Bank of Washington, continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their primary federal banking regulators. In addition, the regulations governing us may be amended from time to time by the respective regulators. Any such legislation or regulatory changes in the future could adversely affect us. We cannot predict whether any such changes may occur.

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Regulation of 1st Security Bank of Washington

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

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

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

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

Insurance of Accounts and Regulation by the FDIC. The Deposit Insurance Fund ("DIF") of the FDIC insures deposit accounts in 1st Security Bank of Washington up to $250,000 per separately insured depositor. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. The Bank's deposit insurance premiums for the year ended December 31, 2014, were $254,000. Those premiums have been reduced in recent years due to management's focus on asset quality, risk management, and growing capital levels.

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

The FDIC conducts examinations of and requires reporting by state non-member banks, such as 1st Security Bank of Washington. The FDIC also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious risk to the deposit insurance fund.

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The FDIC may terminate the deposit insurance of any insured depository institution, including 1st Security Bank of Washington, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is aware of no existing circumstances which would result in termination of 1st Security Bank of Washington's deposit insurance.

Prompt Corrective Action. Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution’s category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is 10% or more, its ratio of core capital to risk-weighted assets is 6% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8%, a core capital to risk-weighted assets ratio of not less than 4%, and a leverage ratio of not less than 4%. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized. In connection with the approval of new capital rules by the federal banking agencies, the general structure of the prompt corrective action rules were maintained, but include a new common equity requirement for Tier 1 capital and incorporate an increased Tier 1 capital requirement into the prompt corrective action framework.

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

At December 31, 2014, 1st Security Bank of Washington was categorized as “well capitalized” under the prompt corrective action regulations of the FDIC. For additional information, see "Capital Requirements" below and Note 13 of the Notes to Consolidated Financial Statements included in Item 8., “Financial Statements and Supplementary Data,” of this Form 10-K.

Capital Requirements. Federally insured financial institutions, such as 1st Security Bank of Washington are required by FDIC regulations to maintain minimum levels of regulatory capital.

At December 31, 2014, FDIC regulations recognized two types, or tiers, of capital: core (Tier 1) capital and supplementary (Tier 2) capital. Tier 1 capital generally includes common shareholders' equity, qualifying restricted core capital elements (other than cumulative perpetual preferred stock), less deductions for disallowed intangibles and disallowed deferred tax assets. Tier 2 capital, which is limited to 100 percent of Tier 1 capital for risk based capital purposes, includes such items as qualifying general loan loss reserves (up to 1.25% of risk-weighted assets), qualified subordinated debt, redeemable preferred stock, other restricted core capital elements, cumulative perpetual preferred stock, and net unrealized holding gains on equity securities (subject to certain limitations); provided, however, the amount of term subordinated debt and intermediate term preferred stock that may be included in Tier 2 capital is limited to 50 percent of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement for a bank to be considered adequately capitalized specifies a minimum ratio of Tier 1 capital to average total assets of 4.0%. At December 31, 2014, the Bank had a Tier 1 leverage capital ratio to average assets of 11.2%. The FDIC retains the right to require a particular institution to maintain a higher capital level based on its particular risk profile.

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FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of that category. In addition, certain off-balance sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, for a bank to be considered adequately capitalized the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets (the total risk-based capital ratio) must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets (the Tier 1 risk-based capital ratio) must be at least 4.0%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect a bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks.

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. The imposition by the FDIC of any of these measures on a bank may have a substantial adverse effect on its operations and profitability.

Institutions with at least a 4.0% Tier 1 capital ratio, a 4.0% Tier 1 risk-based capital ratio and an 8.0% total risk-based capital ratio are considered "adequately capitalized." An institution is deemed "well capitalized" if it has at least a 5% Tier 1 capital ratio, a 6.0% Tier 1 risk-based capital ratio and 10.0% total risk-based capital ratio. Institutions that are not well capitalized are subject to certain restrictions on brokered deposits and interest rates on deposits. At December 31, 2014, the Bank was considered a "well capitalized" institution.

At December 31, 2014, the Bank's equity totaled $55.9 million. Management monitors the capital levels of the Bank to provide for current and future business opportunities and to meet regulatory guidelines for “well capitalized” institutions. The Bank’s actual capital ratios are presented in the following table:

	Actual Ratio		For Capital Adequacy Purposes Ratio		To be Well Capitalized Under Prompt Corrective Action Provisions Ratio	
As of December 31, 2014						
Total risk-based Capital (to risk-weighted assets)	14.68	%	8.00	%	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	13.43	%	4.00	%	6.00	%
Tier 1 leverage capital (to average assets)	11.17	%	4.00	%	5.00	%
As of December 31, 2013						
Total risk-based capital (to risk-weighted assets)	16.64	%	8.00	%	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	15.38	%	4.00	%	6.00	%
Tier 1 leverage capital (to average assets)	12.61	%	4.00	%	5.00	%

On July 2, 2013, the Federal Reserve approved a final rule (“Final Rule”) to establish a new comprehensive regulatory capital framework for all U.S. financial institutions and their holding companies. On July 9, 2013, the Final Rule was approved as an interim final rule by the FDIC. The Final Rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. The Final Rule includes new risk-based capital and leverage ratios, which are effective January 1, 2015, and revise the definition of what constitutes "capital" for purposes of calculating those ratios.

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Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), FS Bancorp and the Bank became subject to the new capital requirements adopted by the Federal Reserve and the FDIC. These new requirements create a new required ratio for common equity Tier 1 ("CET1") capital, increase the leverage and Tier 1 capital ratios, change the risk-weights of certain assets for purposes of the risk-based capital ratios, create an additional capital conservation buffer over the required capital ratios and change what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit our ability and the ability of our bank subsidiary to pay dividends, repurchase shares or pay discretionary bonuses. Under the new capital regulations, the minimum capital ratios applicable to FS Bancorp and the Bank are : (i) a CETI capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from prior rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. CET1 generally consists of common stock; retained earnings; accumulated other comprehensive income ("AOCI"), explained below, unless we elect to exclude AOCI from regulatory capital, as discussed below; and certain minority interests; all subject to applicable regulatory adjustments and deductions. The rule eliminates the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010, will be grandfathered for companies with consolidated assets of $15 billion or less. The rule also establishes a "capital conservation buffer" of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement will be phased in beginning in January 2016, at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. In addition, the new capital rules maintain the general structure of the prompt corrective action rules, but incorporate the new CETI requirement and the increased Tier 1 capital requirement into the prompt corrective action framework, as indicated above in "Prompt Correction Action."

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. An institution is deemed "well capitalized" if it has at least a 5.0% Tier 1 capital ratio, a 6.0% Tier 1 risk-based capital ratio and 10.0% total risk-based capital ratio. At December 31, 2014, we believe that the Bank's current capital levels meet the fully phased in capital requirements, including the related capital conservation buffers, as required by the Final Rule.

For a complete description of the Bank's required and actual capital levels on December 31, 2014, see Note 13 of the Notes to Consolidated Financial Statements included in Item 8., "Financial Statements and Supplementary Data," of this Form 10-K.

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

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Federal Home Loan Bank System. 1st Security Bank of Washington is a member of the FHLB, which is one of 12 regional FHLBs that administer the home financing credit function of savings institutions. The FHLBs are subject to the oversight of the FHFA and each FHLB serves as a reserve or central bank for its members within its assigned region. The FHLBs are funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System and makes loans or advances to members in accordance with policies and procedures established by the Board of Directors of the FHLB. All advances from the FHLB are required to be fully secured by sufficient collateral as determined by the FHLB. In addition, all long-term advances are required to provide funds for residential home financing. See “Business - Deposit Activities and Other Sources of Funds - Borrowings.”

Following its announcement in July 2014, that it had entered into an exclusivity agreement for a potential merger with the FHLB of Des Moines, the FHLB of Seattle and the FHLB of Des Moines entered into a merger agreement on September 25, 2014, for the voluntary merger of the two banks. The merger agreement provides that the FHLB of Des Moines will survive the merger as the resulting bank. The merger was approved by the FHFA in December 2014, and approved by the member-owners of the FHLB of Seattle and the FHLB of Des Moines in February 2015, with a target date of May 31, 2015, for consummation of the merger. As of December 31, 2014, the FHLB of Des Moines had $95.5 billion in assets and served 1,156 member financial institutions in five Mid-Western states, compared to the FHLB of Seattle, which had $35.1 billion in assets and served 316 member financial institutions in eight Western states and the U.S. territories of American Samoa and Guam and the Commonwealth of the Northern Mariana Islands. The combined FHLB will be located in Des Moines and will provide funding for over 1,500 member financial institutions in 13 states, as well as the U.S. territories of American Samoa and Guam and the Commonwealth of the Northern Mariana Islands. Upon completion of the merger, member-owners of the FHLB of Seattle will receive stock in the FHLB of Des Moines equal to the same number of shares held in the FHLB of Seattle prior to the merger. Following completion of the merger, it is anticipated that member-owners of the FHLB of Des Moines and the FHLB of Seattle will hold approximately 82% and 18%, respectively, of the issued and outstanding shares of the resulting bank.

1st Security Bank of Washington, as a member of the FHLB, is required to purchase and maintain stock in the FHLB. At December 31, 2014, 1st Security Bank of Washington had $1.7 million in FHLB stock, which was in compliance with this requirement.

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

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

Dividends. Dividends from 1st Security Bank of Washington constitute a major source of funds for dividends in future periods that may be paid by FS Bancorp to shareholders. The amount of dividends payable by 1st Security Bank of Washington to FS Bancorp depends upon the Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies. According to Washington law, 1st Security Bank of Washington may not declare or pay a cash dividend on its capital stock if it would cause its net worth to be reduced below (1) the amount required for liquidation accounts or (2) the net worth requirements, if any, imposed by the Director of the DFI. Dividends

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on 1st Security Bank of Washington’s capital stock may not be paid in an aggregate amount greater than the aggregate retained earnings of 1st Security Bank of Washington, without the approval of the Director of the DFI.

The amount of dividends actually paid during any one period will be strongly affected by 1st Security Bank of Washington’s policy of maintaining a strong capital position. Federal law further provides that no insured depository institution may pay a cash dividend if it would cause the institution to be “undercapitalized,” as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments are deemed to constitute an unsafe and unsound practice.
Affiliate Transactions. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates, including their bank holding companies. Transactions deemed to be a “covered transaction” under Section 23A of the Federal Reserve Act and between a subsidiary bank and its parent company or the nonbank subsidiaries of the bank holding company are limited to 10% of the bank subsidiary’s capital and surplus and, with respect to the parent company and all such nonbank subsidiaries, to an aggregate of 20% of the bank subsidiary’s capital and surplus. Further, covered transactions that are loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that covered transactions and certain other transactions listed in Section 23B of the Federal Reserve Act between a bank and its affiliates be on terms as favorable to the bank as transactions with non-affiliates.

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

Privacy Standards. The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 ("GLBA") modernized the financial services industry by establishing a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers. 1st Security Bank of Washington is subject to FDIC regulations implementing the privacy protection provisions of the GLBA. These regulations require 1st Security Bank of Washington to disclose its privacy policy, including informing consumers of its information sharing practices and informing consumers of its rights to opt out of certain practices.
Environmental Issues Associated with Real Estate Lending. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") is a federal statute that generally imposes strict liability on, all prior and present "owners and operators" of sites containing hazardous waste. However, Congress asked to protect secured creditors by providing that the term "owner and operator" excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this "secured creditor exemption" has been the subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan. To the extent that legal uncertainty exists in this area, all creditors, including 1st Security Bank of Washington, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.
Federal Reserve System. The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or noninterest-bearing deposits with the regional Federal Reserve Bank. Negotiable order of withdrawal ("NOW") accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are

subject to the reserve requirements, as are any non-personal time deposits at a savings bank. As of December 31, 2014, 1st Security Bank of Washington's deposit with the Federal Reserve Bank and vault cash exceeded its reserve requirements.

Other Consumer Protection Laws and Regulations. The Dodd-Frank Act established the CFPB and empowered it to exercise broad regulatory, supervisory and enforcement authority with respect to both new and existing consumer financial protection laws. 1st Security Bank of Washington is subject to consumer protection regulations

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issued by the CFPB, but as financial institutions with assets of less than $10 billion, 1st Security Bank of Washington is generally subject to supervision and enforcement by the FDIC and the DFI with respect to our compliance with consumer financial protection laws and CFPB regulations.

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

Regulation and Supervision of FS Bancorp

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

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

The Bank Holding Company Act. Under the BHCA, FS Bancorp is supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Federal Reserve provides that bank holding companies should serve as a source of strength to its subsidiary banks by being prepared to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. No regulations have yet been proposed by the Federal Reserve to implement the source of strength doctrine required by the Dodd-Frank Act.

Under the BHCA, the Federal Reserve may approve the ownership of shares by a bank holding company in any company the activities of which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto. These activities generally include, among others, operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

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Acquisitions. The BHCA prohibits a bank holding company, with certain exceptions, from acquiring ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. A bank holding company that meets certain supervisory and financial standards and elects to be designed as a financial holding company may also engage in certain securities, insurance and merchant banking activities and other activities determined to be financial in nature or incidental to financial activities. The BHCA prohibits a bank holding company, with certain exceptions, from acquiring ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries.
Regulatory Capital Requirements. The Federal Reserve has adopted capital guidelines pursuant to which it assesses the adequacy of capital in examining and supervising a bank holding company and in analyzing applications under the BHCA. These guidelines apply on a consolidated basis to bank holding companies with $500 million or more in assets or with fewer assets but certain risky activities, and on a bank-only basis to other companies. These bank holding company capital adequacy guidelines are similar to those imposed on 1st Security Bank of Washington by the FDIC. For a bank holding company with less than $500 million in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. In July 2013, the Federal Reserve and the FDIC approved a new rule that will substantially amend the regulatory risk-based capital rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. For a discussion of the new capital rules, see the section above entitled "-Regulation of 1st Security Bank of Washington - Capital Requirements."
The Company's capital amounts and ratios at December 31, 2014 are presented in the following table.

	Actual			For Capital Adequacy Purposes			To be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
	(Dollars in thousands)								
As of December 31, 2014									
Total risk-based capital (to risk-weighted assets)	$70,927	17.08	%	$33,223	8.00	%	$41,529	10.00	%
Tier I risk-based capital (to risk-weighted assets)	$65,719	15.83	%	$16,611	4.00	%	$24,917	6.00	%
Tier I leverage capital (to average assets)	$65,719	13.16	%	$19,975	4.00	%	$24,969	5.00	%

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

The federal banking agencies are authorized to approve interstate merger transactions without regard to whether the transaction is prohibited by the law of any state, unless the home state of one of the banks adopted a law prior to June

1, 1997, which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-

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of-state banks. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions will also be subject to the nationwide and statewide insured deposit concentration amounts described above.

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

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

Except for a company that meets the well capitalized standard for bank holding companies, is well managed, and is not subject to any unresolved supervisory issues, a bank holding company is required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company's consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation or regulatory order, condition, or written agreement. A bank holding company is considered well capitalized if on a consolidated basis it has a total risk-based capital ratio of at least 10.0% and a Tier 1 risk-based capital ratio of 6.0% or more, and is not subject to an agreement, order, or directive to maintain a specific level for any capital measure.

In addition, federal regulations and polices prohibit a return of capital during the three year term of the business plan submitted by FS Bancorp in connection with the stock offering.

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

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

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

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

The Dodd-Frank Act. On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank-Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions and implements new capital regulations that FS Bancorp and 1st Security Bank of Washington will become subject to and that are discussed above under the section entitled "- Regulation of 1st Security Bank of Washington - Capital Requirements."

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

TAXATION

Federal Taxation

General. FS Bancorp and 1st Security Bank of Washington are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to FS Bancorp. 1st Security Bank of Washington is no longer subject to U.S. federal income tax examinations by tax authorities for years ended before 2011, and income tax returns have not been audited for the past four years, 2011 to 2014. See Note 10 of the Notes to Consolidated Financial Statements included in Item 8., "Financial Statements and Supplementary Data" of this Form 10-K.

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

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

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

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

Washington Taxation

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

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Item 1A. Risk Factors

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

Risks Related to Our Business

Our financial condition and results of operations are dependent on the economy, particularly in 1st Security Bank of Washington's market area. The current economic conditions in the market area served may continue to impact our earnings adversely and could increase the credit risk of our loan portfolio.

Our primary market area is concentrated in the Puget Sound region of Washington. Our business is directly affected by market conditions, trends in industry and finance, legislative and regulatory changes, and changes in governmental monetary and fiscal policies and inflation, all of which are beyond our control. General economic conditions, including inflation, unemployment and money supply fluctuations, also may affect our profitability adversely. Weak economic conditions and ongoing strains in the financial and housing markets could result in higher levels of loan delinquencies, problem assets and foreclosures and a decline in the values of the collateral securing our loans.

A deterioration in economic conditions in the market area we serve could result in the following consequences, any of which could have a material adverse effect on the business, financial condition and results of operations:

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

A decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose real estate loan portfolios are geographically diverse. If we are required to liquidate a significant amount of collateral during a period of reduced real estate values, our financial condition and profitability could be adversely affected.

A return of recessionary conditions could result in increases in our level of non-performing loans and/or reduce demand for our products and services, which could have an adverse effect on our results of operations.

Economic conditions have improved since the end of the economic recession that officially ended in June, 2009; however, economic growth has been slow and uneven, unemployment remains relatively high and concerns still exist over the federal deficit, government spending, global geopolitical risks which have all contributed to diminished expectations for the economy.

A return of recessionary conditions and/or negative developments in the domestic and international credit markets may significantly affect the markets in which we do business, the value of our loans and investments, and our

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ongoing operations, costs and profitability. Declines in real estate values and sales volumes and high unemployment levels may result in higher than expected loan delinquencies and a decline in demand for our products and services. These negative events may cause us to incur losses and may adversely affect our capital, liquidity, and financial condition.

Furthermore, the Board of Governors of the Federal Reserve System, in an attempt to help the economy, has, among other things, kept interest rates low through its targeted federal funds rate and the purchase of U.S. Treasury and mortgage-backed securities. If the Federal Reserve Board increases the federal funds rate, market interest rates would likely rise, which may negatively affect the housing markets and the U.S. economic recovery. In addition, deflationary pressures, while possibly lowering our operating costs, could have a significant negative effect on our borrowers, especially our business borrowers, and the values of underlying collateral securing loans, which could negatively affect our financial performance.

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

Our consumer loans accounted for $136.8 million, or 34.7% of our total loan portfolio as of December 31, 2014, of which $99.3 million (72.6% of total consumer loans) consisted of indirect home improvement loans (some of which were not secured by a lien on the real property), $18.2 million (13.3% of total consumer loans) consisted of solar loans, $16.7 million (12.2% of total consumer loans) consisted of marine loans secured by boats, $674,000 (.5% of total consumer loans) consisted of automobile loans, $441,000 (.3% of total consumer loans) consisted of recreational loans, mainly secured by recreational vehicles and motorcycles, $329,000 (.2% of total consumer loans) consisted of home improvement consumer loans and $1.2 million (.9% of total consumer loans) consisted of other consumer loans. Generally, we consider these types of loans to involve a higher degree of risk compared to first mortgage loans on owner-occupied, one-to-four-family residential properties. As a result of our large portfolio of consumer loans, it may become necessary to increase the level of provision for our loan losses, which would reduce profits. Consumer loans generally entail greater risk than do one-to-four-family residential mortgage loans, particularly in the case of loans that are secured by rapidly depreciable assets, such as automobiles and boats. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance.

Most of our consumer loans are originated indirectly by or through third parties, which presents greater risk than our direct lending products which involves direct contact between us and the borrower. Unlike a direct loan where the borrower makes an application directly to us, in these loans the dealer, who has a direct financial interest in the loan transaction, assists the borrower in preparing the loan application. Although we disburse the loan proceeds directly to the borrower upon receipt of a “completion certificate” signed by the borrower, because we do not have direct contact with the borrower, these loans may be more susceptible to a material misstatement on the loan application or having the loan proceeds being misused by the borrower or the dealer. In addition, if the work is not properly performed, the borrower may cease payment on the loan until the problem is rectified.

Indirect home improvement and solar loans totaled $117.5 million, or 29.8% of our total gross loan portfolio at December 31, 2014, and are originated through a network of approximately 132 home improvement contractors and dealers located in Washington, Oregon and California. As of December 31, 2014, the Company had $17.7 million in loans to borrowers that reside in California. Adverse economic conditions in California, including an increase in the level of unemployment, or a decline in real estate values could adversely affect the ability of these borrowers to make loan payments to us.

In addition, we rely on three dealers for a majority or 56.1% of our loan volume so the loss of one of these dealers can have a significant effect on our loan origination volume. See Item 1., “Business of 1st Security Bank of Washington - Lending Activities - Consumer Lending” and “- Asset Quality.”

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

Our indirect home improvement lending, which is the largest component of our loan portfolio, is reliant on our relationships with home improvement contractors and dealers. In particular, our indirect home improvement loan operations depend in large part upon our ability to establish and maintain relationships with reputable contractors and dealers who originate loans at the point of sale. Our indirect home improvement contractor/dealer network is currently comprised of approximately 132 active contractors and dealers with businesses located throughout Washington, Oregon

and California with approximately three contractors/dealers responsible for more than half of this loan volume. Indirect home improvement and solar loans totaled $117.5 million, or 29.8% of our total gross loan portfolio, as of December 31, 2014, reflecting approximately 13,000 loans with an average balance of approximately $9,000.
We have relationships with home improvement contractors/dealers, however, the relationships generally are not exclusive, some of them are newly established and they may be terminated at any time. If there is another economic downturn and contraction of credit to both contractors/dealers and their customers, there could be an increase in business closures and our existing contractor/dealer base could experience decreased sales and loan volume, which may have an adverse effect on our business, results of operations and financial condition. In addition, if a competitor were to offer better service or more attractive loan products to our contractor/dealer partners, it is possible that our partners would terminate their relationships with us or recommend customers to our competitors. If we are unable to continue to grow our existing relationships and develop new relationships, our results of operations and financial condition could be adversely affected.
In the fourth quarter of 2012, we expanded consumer solar loan originations in California which enabled us to increase sales of consumer solar loans from $2.5 million at the beginning of 2013 to $16.8 million at the end of 2013. This growth continued in 2014 and resulted in $27.2 million in consumer solar loan sales during the year ended December 31, 2014. We have adopted limits on California lending to be no more than 20% of the total consumer portfolio. As of December 31, 2014, the maximum level of California originated consumer solar loans would be $27.4 million. As of December 31, 2014, we held $17.7 million of these consumer solar loans to borrowers located in California.
A significant portion of our business involves commercial business, commercial construction and commercial real estate lending which is subject to various risks that could adversely impact our results of operations and financial condition.

At December 31, 2014, our loan portfolio included $194.9 million of commercial real estate, commercial construction, multi-family real estate loans, and commercial business loans, or 49.4% of our total gross loan portfolio, compared to $128.5 million, or 44.7%, at December 31, 2013. We have been increasing and intend to continue to increase, subject to market demand, the origination of commercial real estate and commercial business loans. The credit risk related to these types of loans is considered to be greater than the risk related to one-to-four-family residential loans because the repayment of commercial real estate loans and commercial business loans typically is dependent on the successful operation and income stream of the property securing the loan and/or the borrowers' business and the value of the real estate securing the loan as collateral, which can be significantly affected by economic conditions.
Our renewed focus on these types of lending will increase the risk profile relative to traditional one-to-four-family lenders as we continue to implement our business strategy. Although commercial business and commercial real estate loans are intended to enhance the average yield of the earning assets, they do involve a different, and possibly higher, level of risk of delinquency or collection than generally associated with one-to-four-family loans for a number of reasons. Among other factors, these loans involve larger balances to a single borrower or groups of related borrowers. Since commercial business, commercial construction and commercial real estate loans generally have large balances, if we make any errors in judgment in the collectability of these loans, we may need to significantly increase the provision for loan losses since any resulting charge offs will be larger on a per loan basis. Consequently, this could materially adversely affect our future earnings. Collateral evaluation and financial statement analysis in these types of loans also requires a more detailed analysis at the time of loan underwriting and on an ongoing basis. Finally, if foreclosure occurs on a commercial real estate loan, the holding period for the collateral, if any, typically is longer than for a one-to-four-family residence because the secondary market for most types of commercial real estate is not readily liquid, so we have less opportunity to mitigate credit risk by selling part or all of our interest in these assets. See Item 1., "Business of 1st Security Bank of Washington - Lending Activities - Commercial Real Estate Lending" of this Form 10-K.

Our mortgage warehouse lending program is subject to various risks that could adversely impact our results of operations and financial condition.

In October 2009, we commenced a mortgage warehouse lending program. Our mortgage warehouse lending program focuses on six Pacific Northwest mortgage banking companies. Short term funding is provided to the mortgage banking companies for the purpose of originating residential mortgage loans for sale into the secondary market. Our warehouse lending lines are secured by the underlying notes associated with mortgage loans made to borrowers by the mortgage banking company and we generally require guarantees from the principle shareholder(s) of the mortgage banking company. These loans are repaid when the note is sold by the mortgage bank into the secondary market, with the proceeds from the sale used to pay down the outstanding loan before being dispersed to the mortgage bank. As of December 31, 2014, we had approved warehouse lending lines in varying amounts from $3.0 million to $9.0 million with each of the six companies, for an aggregate amount of $34.0 million. During the year ended December 31, 2014, we processed approximately 1,000 loans and funded approximately $272.1 million under this program. Our mortgage warehouse related gross revenues totaled $573,000 for the year ended December 31, 2014. As of December 31, 2014, there was $10.1 million in warehouse lines outstanding, compared to $4.0 million outstanding at December 31, 2013. There are numerous risks associated with this type of lending, which include, without limitation, (i) credit risks relating to the mortgage bankers that borrow from us, (ii) the risk of intentional misrepresentation or fraud by any of these mortgage bankers, (iii) changes in the market value of mortgage loans originated by the mortgage banker, the sale of which is the expected source of repayment of the borrowings under the warehouse line of credit, due to changes in interest rates during the time in warehouse, (iv) unsalable or impaired mortgage loans so originated, which could lead to decreased collateral value and the failure of a purchaser of the mortgage loan to purchase the loan from the mortgage banker, and (v) the volatility of mortgage loan originations.

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

Our lending limit may limit growth.

The Board of Directors have implemented a policy lending limit that it believes matches the Washington State legal lending limit. Our policy limits loans to one borrower and the borrower’s related entities to 20% of our unimpaired capital and surplus, or $12.4 million at December 31, 2014. Management has adopted a limit of $9.5 million for risk mitigation purposes and all relationships above this level require full Board approval. These amounts are significantly less than that of many of our competitors and may discourage potential commercial borrowers who have credit needs in excess of our lending limit from doing business with us. The lending limit also impacts the efficiency of our commercial lending operation because it tends to lower the average loan size, which means a higher number of transactions have to be generated to achieve the same portfolio volume. We can accommodate larger loans by selling participations in those loans to other financial institutions, but this strategy is not efficient or always available. We may not be able to attract or maintain clients seeking larger loans or may not be able to sell participations in these loans on terms that are considered favorable.

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

To assist in expanding our residential construction lending program, we hired several new experienced construction lenders in the third quarter of 2011 with the focus of lending up to 100% of total risk-based capital in construction and development lending. Our residential construction lending program focuses on the origination of loans to builders, both pre-sold and speculative, for the purpose of constructing and selling primarily one-to-four-family residences within the market area. Our construction and development loans totaled $57.8 million, or 14.7%, of total gross loans at December 31, 2014. The Company's total risk-based capital was $70.9 million as of December 31, 2014. Construction and development lending contains the inherent difficulty in estimating both a property’s value at completion of the project and the estimated cost (including interest) of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. In addition, during the term of most of our construction loans, an interest reserve is created at origination and is added to the principal of the loan through the construction phase. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. Speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk than construction loans to individuals on their personal residences. Loans on land under development or held for future construction pose additional risk because of

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the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be significantly impacted by supply and demand. As a result, this type of lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor themselves to repay principal and interest.

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

In an effort to diversify our revenue streams and to generate additional income, we hired several experienced bankers to reintroduce in-house originations of residential mortgage loans through a mortgage banking program in 2012. We expect to hire additional staff throughout 2015 to support our originations. Our mortgage banking program, which started in the fourth quarter of 2011, is dependent upon our ability to originate and sell loans to investors. Mortgage revenues are primarily generated from gains on the sale of one-to-four-family residential loans underwritten to programs currently offered by Fannie Mae, Freddie Mac, FHA, VA, USDA Rural Housing and other non-GSE investors. These entities account for a substantial portion of the secondary market in residential mortgage loans. We sell loans on both a servicing retained and servicing released basis utilizing market execution analysis and customer relationships as the criteria. Any future changes in these programs, our eligibility to participate in these programs, the criteria for loans to be accepted or laws that significantly affect the activity of these entities could, in turn, materially adversely affect the success of our mortgage banking program and, consequently, our results of operations.

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

Currently, as a result of government actions and other economic factors related to the economic downturn, interest rates are at historically low levels. It is unknown how long interest rates will remain at these historically low levels. To the extent that market interest rates increase in the future, our ability to originate mortgage loans held for sale may decrease, resulting in fewer loans that are available to be sold to investors. This would adversely affect our ability to generate mortgage revenues, and consequently noninterest income. Because interest rates depend on factors outside of our control, we cannot eliminate the interest rate risk associated with our mortgage operations.

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

Finally, deteriorating economic conditions may also increase the potential for home buyers to default on their mortgages. In certain of these cases where we have originated loans and sold them to investors, we may be required to repurchase loans or provide a financial settlement to investors if it is proven that the borrower failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor. Such repurchases or settlements would also adversely affect our net income.

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

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review loans and our historical loss and delinquency experience, and evaluate economic conditions. Management recognizes that significant new growth in loan portfolios, new loan products and the refinancing of existing loans can result in portfolios comprised of unseasoned loans that may not perform in a historical or projected manner. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover actual losses, resulting in additional provisions for loan losses to replenish the allowance for loan losses. Deterioration in economic conditions, new information regarding existing

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loans, identification of additional problem loans or relationships, and other factors, both within and outside of our control, may increase our loan charge-offs and/or may also otherwise also require an increase in our provision for loan losses.

Our allowance for loan losses was 1.5% of total gross loans, and 1,406.5% of non-performing loans at December 31, 2014, compared to 1.8% of total gross loans, and 462.5% of non-performing loans at December 31, 2013. In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize additional loan charge-offs. Any increases in the provision for loan losses may result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations, and capital.

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

During the periods from January 1, 2012 through December 31, 2014, we originated $230.4 million of loans, including loans in process, with an outstanding balance of $164.4 million, as of December 31, 2014. As a result, a significant portion of the portfolio is relatively unseasoned and some borrowers may not have had sufficient time to perform to properly indicate the magnitude of potential losses. These loans may have delinquency or charge-off levels above our historical experience, which could adversely affect our future performance.

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

At December 31, 2014, $46.8 million, or 11.9% of our total loan portfolio, was secured by first liens on one-to-four-family residential loans and our home equity lines of credit totaled $15.7 million, or 4.0% of our total loan portfolio. These types of loans are generally sensitive to regional and local economic conditions that significantly impact the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. A decline in residential real estate values resulting from a downturn in the Washington housing markets in which our loans are concentrated may reduce the value of the real estate collateral securing these types of loans and increase our risk of loss if borrowers default on their loans. A decline in economic conditions or in the volume of real estate sales and/or the sales prices coupled with elevated unemployment rates may result in higher than expected loan delinquencies or problem assets, and a decline in demand for our products and services. In addition, residential loans with high combined loan-to-value ratios will be more sensitive to the fluctuation of property values than those with lower combined loan-to-value ratios and therefore may experience a higher incidence of default and severity of losses. Further, the majority of our home equity lines of credit consist of second mortgage loans. For those home equity lines secured by a second mortgage, it is unlikely that we will be successful in recovering all or a portion of our loan proceeds in the event of default unless we are prepared to repay the first mortgage loan and such repayment and the costs associated with a foreclosure are justified by the value of the property. For these reasons, we may experience higher rates of delinquencies, defaults and losses which would adversely affect our net income.

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

At December 31, 2014, $20.3 million, or 5.1% of our total loan portfolio, consisted of loans secured by non-owner occupied commercial real estate properties. Loans secured by non-owner occupied properties generally expose a lender to greater risk of non-payment and loss than loans secured by owner occupied properties because repayment of such loans depend primarily on the tenant’s continuing ability to pay rent to the property owner, who is our borrower, or, if the property owner is unable to find a tenant, the property owner’s ability to repay the loan without the benefit of a rental income stream. Furthermore, some of our non-owner occupied commercial loan borrowers have more than one loan outstanding with us. At December 31, 2014, we had three non-owner occupied commercial loan relationships, each having an outstanding balance over $500,000, with aggregate outstanding balances of $5.1 million. Consequently, an adverse development with respect to one credit relationship may expose us to a greater risk of loss compared to an adverse development with respect to an owner occupied commercial real estate loan.

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Our securities portfolio may be negatively impacted by fluctuations in market value and interest rates.
Our securities portfolio may be impacted by fluctuations in market value, potentially reducing accumulated other comprehensive income and/or earnings. Fluctuations in market value may be caused by changes in market interest rates, lower market prices for securities and limited investor demand. Our securities portfolio is evaluated for other-than-temporary impairment. If this evaluation shows impairment to the actual or projected cash flows associated with one or more securities, a potential loss to earnings may occur. Changes in interest rates can also have an adverse effect on our financial condition, as our available-for-sale securities are reported at their estimated fair value, and therefore are impacted by fluctuations in interest rates. We increase or decrease our shareholders' equity by the amount of change in the estimated fair value of the available-for-sale securities, net of taxes. There can be no assurance that the declines in market value will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our net income and capital levels.
New lines of business or new products and services may subject us to additional risk.

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

We have recently hired a number of experienced bankers in the area of residential mortgage banking. We expect to hire additional personnel in this area in order to successfully carryout our business plan. The difficulties in hiring and training new personnel include integrating personnel with different business backgrounds, and combining different corporate cultures, while retaining other key employees. The process of integrating personnel could cause an interruption of, or loss of momentum in our operations and the loss of customers and key personnel. In addition, we may not realize expected revenue increases and other projected benefits from the increased emphasis in this lending area. Any delays or difficulties encountered in connection with integrating and growing of this portion of our operations could have an adverse effect on our business and results of operations or otherwise adversely affect our ability to achieve the anticipated results.
Changes in interest rates may reduce our net interest income, and may result in higher defaults in a rising rate environment.

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but these changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

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Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition, liquidity and results of operations. Further, a prolonged period of exceptionally low market interest rates, such as we are currently experiencing and the Board of Governors of the Federal Reserve System has indicated it intends to maintain, limits our ability to lower our interest expense, while the average yield on our interest-earning assets may decrease as our loans reprice or are originated at these low market rates. Accordingly, our net interest income may decrease, which may have an adverse effect on our profitability. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet or projected operating results. See Item 7., “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management and Market Risk” of this Form 10-K.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans or other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance activities or the terms of which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the Washington markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets. See Item 7., “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity” included herein.

Loss of key employees may disrupt relationships with certain customers.

Our business is primarily relationship-driven in that some of our business development and relationship managers have extensive customer relationships. Loss of such key personnel could result in the loss of some of our customers. While we believe the relationship with key producers is good, we cannot guarantee that all of the key personnel will remain with our organization. The loss of these key persons could negatively impact the affected banking operations.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. These competitors primarily include national, regional and internet banks within the various markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, mortgage banking finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Also, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

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

- the ability to develop, maintain and build upon long-term customer relationships based on top-quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;

- the scope, relevance and pricing of products and services offered to meet customer needs and demands;

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- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

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

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

We are currently subject to extensive examination, supervision and comprehensive regulation by the FDIC and the DFI. The FDIC and the DFI govern the activities in which we may engage, primarily for the protection of depositors and the DFI. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution's operations, reclassify assets, determine the adequacy of an institution's allowance for loan losses and determine the level of deposit insurance premiums assessed. These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time. Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, and/or increase the ability of non-banks to offer competing financial services and products, among other things. Further, changes in accounting standards can be both difficult to predict and involve judgment and discretion in their interpretation by us and our independent accounting firms. These changes could materially impact, potentially even retroactively, how we report our financial condition and results of our operations as could our interpretation of those changes.

Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has significantly changed the bank regulatory structure and will affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Certain provisions of the Dodd-Frank Act are expected to have a near term impact on us. For example, a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.

The Dodd-Frank Act also created a new Consumer Financial Protection Bureau ("CFPB") with broad powers to supervise and enforce consumer protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has examination and enforcement authority over all banks with more than $10 billion in assets. Financial institutions such as 1st Security Bank of Washington with $10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators.

In January of 2013, the CFPB issued several final regulations and changes to certain consumer protections under existing laws. These final rules, most of the provisions of which (including the qualified mortgage rule) became effective January 10, 2014, generally prohibit creditors from extending mortgage loans without regard for the consumer's ability-to-repay and add restrictions and requirements to mortgage origination and servicing practices. In addition, these rules limit prepayment penalties and require the creditor to retain evidence of compliance with the ability-to-repay requirement for three years. Compliance with these rules will likely increase our overall regulatory compliance costs and may require changes to our underwriting practices with respect to mortgage loans. Moreover, these rules may adversely affect the volume of mortgage loans that we underwrite and may subject us to increased potential liabilities related to such residential loan origination activities.

The Dodd-Frank Act requires minimum leverage (Tier 1) and risk-based capital requirements for savings and loan holding companies and bank holding companies that are no less stringent than those applicable to banks, which will limit our ability to borrow at the holding company level and invest the proceeds from such borrowings as capital in the Bank, and will exclude certain instruments that previously have been eligible for inclusion by bank holding companies as Tier 1 capital.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs, which could adversely affect key operating efficiency ratios, and could increase our interest expense. See Item 1., “Business - How We are Regulated” of this Form 10-K.

Any other additional changes in our regulation and oversight, whether in the form of new laws, rules or regulations, could likewise make compliance more difficult or expensive or otherwise materially adversely affect our business, financial condition or prospects.

Non-compliance with the USA PATRIOT Act, Bank Secrecy Act, or other laws and regulations could result in fines or sanctions.

The USA PATRIOT and Bank Secrecy Acts require financial institutions to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the U.S. Treasury’s Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure to comply with these regulations could result in fines or sanctions. During the last few years, several banking institutions have received large fines for non-compliance with these laws and regulations. While we have developed policies and procedures designed to assist in compliance with these laws and regulations, no assurance can be given that these policies and procedures will be effective in preventing violations of these laws and regulations.

We are subject to certain risks in connection with our use of technology.

Our security measures may not be sufficient to mitigate the risk of a cyber attack. Communications and information systems are essential to the conduct of our business, as we use such systems to manage our customer relationships, our general ledger and virtually all other aspects of our business. Our operations rely on the secure processing, storage, and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, the security of our computer systems, software, and networks may be vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious code and cyber attacks that could have a security impact. If one or more of these events occur, this could jeopardize our or our customers' confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties. We may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against or not fully covered through any insurance maintained by us. We could also suffer significant reputational damage.

Security breaches in our internet banking activities could further expose us to possible liability and damage our reputation. Any compromise of our security also could deter customers from using our Internet banking services that involve the transmission of confidential information. We rely on standard Internet security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures, which could result in significant legal liability and significant damage to our reputation and our business.

Our security measures may not protect us from systems failures or interruptions. While we have established policies and procedures to prevent or limit the impact of systems failures and interruptions, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. In addition, we outsource certain aspects of our data processing and other operational functions to certain third-party providers. If our third-party providers encounter difficulties, or if we have difficulty in communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely impacted. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

The occurrence of any failures or interruptions may require us to identify alternative sources of such services and we cannot assure you that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all. Further, the occurrence of any systems failure or interruption could damage our reputation and result in a loss of customers and business, could subject us to additional regulatory scrutiny, or could expose us to legal liability. Any of these occurrences could have a material adverse effect on our financial condition and results of operations.

Our business may be adversely affected by an increasing prevalence of fraud and other financial crimes.
Our loans to businesses and individuals and our deposit relationships and related transactions are subject to exposure to the risk of loss due to fraud and other financial crimes. Nationally, reported incidents of fraud and other financial crimes have increased. We have also experienced losses due to apparent fraud and other financial crimes. While we have policies and procedures designed to prevent such losses, there can be no assurance that such losses will not occur.
If our investment in the Federal Home Loan Bank of Seattle becomes impaired, our earnings and shareholders’ equity could decrease.

At December 31, 2014, we owned $1.7 million in FHLB of Seattle stock. We are required to own this stock to be a member of and to obtain advances from the FHLB. This stock is not marketable and can only be redeemed by our FHLB, with the permission of its regulators as the FHLB of Seattle is currently operating under a consent order entered into with its primary federal regulator. Our FHLB's financial condition is linked, in part, to the eleven other members of the FHLB System and to accounting rules and asset quality risks that could materially lower their capital, which would cause our FHLB stock to be deemed impaired, resulting in a decrease in our earnings and assets.
On September 25, 2014, the FHLB Seattle and FHLB Des Moines announced a proposed merger. Under this proposal, the Bank would become a member of FHLB Des Moines and all shares of our FHLB Seattle stock would convert to equal shares of FHLB Des Moines stock. If the merger is terminated by either the FHLB Des Moines or the FHLB Seattle , the terminating FHLB must pay $57 million in termination fees. If the FHLB Seattle were to terminate the agreement, this could result in significant impairment to our investment in the FHLB Seattle, potentially decreasing our earnings and shareholders' equity.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

At December 31, 2014, the Company had one administrative office, five loan origination offices and seven full-service banking branch offices with an aggregate net book value of $13.6 million. The following table sets forth certain information concerning the offices at December 31, 2014. See also Note 5 of the Notes to Consolidated Financial Statements included in Item 8., "Financial Statements and Supplementary Data" of this Form 10-K. In the opinion of management, the facilities are adequate and suitable for the Company needs.

Location	Square Footage	Owned or Leased	Lease Expiration Date	Net Book Value at December 31, 2014 [(1)] (In thousands)
Canyon Park 22020 17th Ave SE, Suite 100 Bothell, WA 98021	2,997	Leased	May 2015 [(2)]	$16
Edmonds 620 Edmonds Way Edmonds, WA 98020	2,474	Owned	—	$1,403
Lynnwood 19002 33rd Ave W Lynnwood, WA 98036	3,000	Leased	June 2020	$138
Mountlake Terrace (Administrative) 6920 220th St SW Mountlake Terrace, WA 98043	39,535	Owned	—	$6,728
Poulsbo21650 Market Place Poulsbo, WA 98370	3,498	Owned	—	$2,873
Puyallup307 W Stewart St Puyallup, WA 98371	2,474	Owned	—	1,333
Bellevue Home Lending1110 112th Avenue NE, Suite 310 Bellevue, WA, 98004	4,068	Leased	December 2017	77
Overlake14808 NE 24th St, Suite D Redmond, WA 98052	2,331	Leased	May 2016	133

(1) Net book value includes investment in premises, equipment and leaseholds.
(2) This office location is being closed with branch staff and deposit accounts transferring to a new location in Mill Creek, WA, which will open in the second quarter of 2015.

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Location		Square Footage	Owned or Leased	Lease Expiration Date	Net Book Value at December 31, 2014 (1) (In thousands)
Capitol Hill Broadway East Seattle, WA 98102	614	5,100	Leased	December 2022 (4)	$706
Port Orchard Home Lending Avenue, Suite 202 Port Orchard, WA 98366	1140 Bethel	330	Leased	Month-to-Month	$55
Puyallup Home Lending Meridian, Suite 180 Puyallup, WA 98373	2910 S	3,389	Leased	June 2019 (3)	$56
Tri-Cities Home Lending West Gage Blvd, Suite A Kennewick, WA 99336	8486	5,477	Leased	March 2020	$62
Canyon Park Home Lending SE, Suite 220 Bothell, WA 98021	22020 17th Ave	1,455	Leased	February 2015	$4

(3) Lease provides for one five-year renewal option.
(4) Lease provides for two five-year renewal options.

The Company maintains depositor and borrower customer files on an on-line basis, utilizing a telecommunications network, portions of which are leased. The book value of all data processing and computer equipment utilized by the Company at December 31, 2014, was $627,000. Management has a business continuity plan in place with respect to the data processing system, as well as the Company's operations as a whole.

Item 3. Legal Proceedings

Because of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company’s common stock is traded on The NASDAQ Stock Market LLC’s Global Market, under the symbol “FSBW.” As of December 31, 2014, there were 3,235,625 shares of common stock issued and outstanding and approximately 155 shareholders of record based upon securities position listings furnished to us by our transfer agent. This total does not reflect the number of persons or entities who hold stock in nominee or “street name” accounts with brokers. The tables below show the high and low closing prices and quarterly cash dividends for our common stock for the periods indicated.

Year ended December 31, 2014	High	Low	Cash dividends declared and paid
First quarter	$17.20	$16.35	$0.06
Second quarter	17.47	16.23	0.06
Third quarter	17.40	16.95	0.06
Fourth quarter	18.25	16.68	0.06

Year ended December 31, 2013	High	Low	Cash dividends declared and paid
First quarter	$16.47	$12.90	$0.05
Second quarter	18.37	15.70	0.05
Third quarter	17.92	16.57	0.05
Fourth quarter	17.28	16.60	0.05

1st Security Bank of Washington is a wholly-owned subsidiary of FS Bancorp. Under federal regulations, the dollar amount of dividends 1st Security Bank of Washington may pay to FS Bancorp depends upon its capital position and recent net income. Generally, if 1st Security Bank of Washington satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed by state law and FDIC regulations. See “Item 1. Business - How We Are Regulated - Regulation of 1st Security Bank of Washington- Dividends” and “--Regulation of FS Bancorp- Restrictions on Dividends and Stock Repurchases”.

The cash dividend policy is reviewed by management and the Board of Directors. Any dividends declared and paid in the future would depend upon a number of factors including capital requirements, the Company's financial condition and results of operations, tax considerations, statutory and regulatory limitations, and general economic conditions. No assurances can be given that any dividends will be paid or that, if paid, will not be reduced or eliminated in future periods.

Stock Repurchases in the Fourth Quarter. Not applicable.

Equity Compensation Plan Information. The equity compensation plan information presented under subparagraph (d) in Part III, Item 12 of this report is incorporated herein by reference.

Performance Graph. The following graph compares the cumulative total shareholder return on the Company's common stock with the cumulative total return on the NASDAQ Stock Index (U.S. Stock) and NASDAQ Bank Index. Total return assumes the reinvestment of all dividends and that the value of common stock and bank index was $100 on July 10, 2012.

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Source: SNL Financial LC, Charlottesville, VA

	Periods Ended					
Index	07/10/12	12/31/12	06/30/13	12/31/13	06/30/14	12/31/14
FS Bancorp, Inc.	100.00	129.57	180.36	172.84	176.50	186.41
S&P 500	100.00	107.51	122.37	142.33	152.49	161.82
SNL Bank $250M-$500M	100.00	105.02	125.08	142.60	156.99	162.72

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Item 6. Selected Financial Data

The following table sets forth certain information concerning the Company's consolidated financial position and results of operations at and for the dates indicated and have been derived from the audited consolidated financial statements. The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with Item 7., "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8., "Financial Statements and Supplementary Data."

	At December 31,				
	2014	2013	2012	2011	2010
	(In thousands)				
Selected Financial Condition Data:					
Total assets	$509,754	$419,187	$359,030	$283,793	$292,334
Loans receivable, net[1]	387,174	281,081	274,949	217,131	230,822
Loans held for sale	25,983	11,185	8,870	—	—
Securities available-for-sale, at fair value	48,744	56,239	43,313	26,899	7,642
FHLB stock	1,650	1,702	1,765	1,797	1,797
Deposits	420,444	336,876	288,949	246,418	243,957
Borrowings	17,034	16,664	6,840	8,900	21,900
Total equity	65,836	62,313	59,897	26,767	24,795

	Years Ended December 31,				
	2014	2013	2012	2011	2010
	(In thousands)				
Selected Operations Data:					
Total interest and dividend income	$24,842	$21,733	$18,787	$16,478	$17,333
Total interest expense	2,702	2,178	2,363	3,006	3,886
Net interest income	22,140	19,555	16,424	13,472	13,447
Provision for loan losses	1,800	2,170	2,913	2,369	3,480
Net interest income after provision for loan losses	20,340	17,385	13,511	11,103	9,967
Fees and service charges	1,762	1,807	1,993	1,971	2,255
Gain on sale of loans	7,577	6,371	3,684	113	—
Gain on sale of assets / impairment (loss) on long-lived assets	(9)	—	165	59	1,006
Gain (loss) on sale of investment securities	(41)	264	—	—	—
Other noninterest income	744	473	322	332	406
Total noninterest income	10,033	8,915	6,164	2,475	3,667
Total noninterest expense	23,902	20,361	16,477	12,033	12,032
Income before provision (benefit) for income taxes	6,471	5,939	3,198	1,545	1,602
Provision (benefit) for income tax	1,931	2,019	(2,097)	—	—
Net income	$4,540	$3,920	$5,295	$1,545	$1,602

(1) Net of allowances for loan losses, loans in process and deferred loan costs, fees, and discounts.

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	At or For the Years Ended December 31, 2014		2013		2012		2011		2010	
Selected Financial Ratios and Other Data										
Performance ratios:										
Return on assets (ratio of net income to average total assets)	1.00	%	1.01	%	1.64	%	0.56	%	0.60	%
Return on equity (ratio of net income to average equity)	7.19		6.43		12.71		5.92		6.54	
Yield on average interest-earning assets	5.74		5.93		6.21		6.35		6.86	
Rate paid on average interest-bearing liabilities	0.80		0.77		0.94		1.31		1.75	
Interest rate spread information:										
Average during period	4.94		5.16		5.27		5.04		5.11	
Net interest margin[1]	5.12		5.33		5.43		5.19		5.32	
Operating expense to average total assets	5.27		5.27		5.12		4.35		4.49	
Average interest-earning assets to average interest-bearing liabilities	128.30		129.73		120.34		112.90		113.98	
Efficiency ratio[2]	74.29		71.52		72.95		75.46		70.31	
Margin on loans held for sale [3]	2.31		2.37		2.47		—		—	
Asset quality ratios:										
Non-performing assets to total assets at end of period[4]	0.08	%	0.77	%	1.13	%	2.43	%	3.45	%
Non-performing loans to total gross loans[5]	0.11		0.38		0.68		1.01		2.66	
Allowance for loan losses to non-performing loans[5]	1,406.47		462.49		246.48		195.11		93.70	
Allowance for loan losses to gross loans receivable	1.54		1.77		1.68		1.97		2.50	
Capital ratios:										
Equity to total assets at end of period	12.92	%	14.87	%	16.68	%	9.43	%	8.48	%
Average equity to average assets	13.92		15.78		12.93		9.44		9.13	
Other data:										
Number of full service offices	7		7		6		6		6	
Full-time equivalent employees	209		158		130		86		79	
Net income per common share:										
Basic	$1.52		$1.29		$1.76		nm[6]		nm[6]	
Diluted	$1.52		$1.29		$1.76		nm[6]		nm[6]	
Book values:										
Book value per common share	$22.10	[9]	$20.55	[8]	$19.92	[7]	nm[6]		nm[6]	

(1) Net interest income divided by average interest earning assets.

(2) Total noninterest expense as a percentage of net interest income and total other noninterest income.
(3) Mortgage loan program started in 2012; no activity related to loans held for sale in prior years.
(4) Non-performing assets consists of non-performing loans (which include non-accruing loans and accruing loans more than 90 days past due), foreclosed real estate and other repossessed assets.
(5) Non-performing loans consists of non-accruing loans and accruing loans more than 90 days past due.
(6) Not meaningful as the Company completed the stock offering on July 9, 2012.
(7) Book value per common share was calculated using shares outstanding of 3,240,125 at December 31, 2012, less unallocated ESOP shares of 233,289.
(8) Book value per common share was calculated using shares outstanding of 3,240,125 at December 31, 2013, less unallocated ESOP shares of 207,368.
(9) Book value per common share was calculated using shares outstanding of 3,235,625 at December 31, 2014, less unallocated ESOP shares of 181,447.

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Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

This discussion and analysis reviews our consolidated financial statements and other relevant statistical data and is intended to enhance your understanding of our financial condition and results of operations. The information in this section has been derived from the Consolidated Financial Statements and footnotes thereto that appear in Item 8 of this Form 10-K. The information contained in this section should be read in conjunction with these Consolidated Financial Statements and footnotes and the business and financial information provided in this Form 10-K.

Overview

FS Bancorp, Inc. and its subsidiary bank, 1st Security Bank of Washington have been serving the Puget Sound area since 1936. Originally chartered as a credit union, previously known as Washington’s Credit Union, the credit union served various select employment groups. On April 1, 2004, the credit union converted to a Washington state-chartered mutual savings bank. On July 9, 2012, the Bank converted from mutual to stock ownership and became the wholly owned subsidiary of FS Bancorp, Inc.

1st Security Bank of Washington is a relationship-driven community bank delivering banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Bank emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Bank is also actively involved in community activities and events within these market areas, which further strengthens relationships within these markets.

The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, commercial real estate mortgage loans, home loans, commercial business loans and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans to finance window replacement, gutter replacement, siding replacement, solar panels, and other improvement renovations, represent the largest portion of the loan portfolio and have traditionally been the mainstay of our lending strategy. As of December 31, 2014, consumer loans represented 34.7% of the total portfolio, with indirect home improvement loans representing 72.6% and solar loans representing 13.3% of the total consumer loan portfolio.

Indirect home improvement lending is reliant on the Company’s relationships with home improvement contractors and dealers. The Company’s indirect home improvement contractor/dealer network is currently comprised of approximately 132 active contractors and dealers with businesses located throughout Washington, Oregon, and California, with approximately three contractors/dealers responsible for a majority or 56.1% of this loan volume. The Company began originating consumer indirect loans in the State of California in 2012 with $2.5 million in these loans originated during 2012. In 2014, the Company originated $27.2 million in the State of California and held $17.7 million in California originated consumer loans as of December 31, 2014. Management has established a limit of no more than 20% of the total consumer loan portfolio for loans in California. As of December 31, 2014, the limit would be $27.4 million. See Item 1A., “Risk Factors – Our business could suffer if we are unsuccessful in making, continuing and growing relationships with home improvement contractors and dealers" of this Form 10-K.

Since 2012, the Company has had an emphasis on diversifying lending products by expanding commercial real estate, commercial business and residential lending, while maintaining the current size of the consumer loan portfolio. The Company’s lending strategies are intended to take advantage of: (1) historical strength in indirect consumer lending, (2) recent market consolidation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as an important funding source. See Item 1A., “Risk Factors – Risks Related to Our Business” in this Form 10-K.

The Company is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs. Deposit flows are influenced by a number of factors, including interest rates paid on time deposits, other investments, account maturities, and the overall level of personal income and savings. Lending activities are influenced by the demand for funds, the number and quality of lenders, and regional economic cycles. Sources of funds for lending activities include primarily deposits, including brokered deposits, borrowings, payments on loans and income provided from operations.

The Company’s earnings are primarily dependent upon net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings. The Company's earnings are also affected by the provision for loan losses, service charges and fees, gains from sales of assets, operating expenses and income taxes.

Critical Accounting Policies and Estimates

Certain of the Company’s accounting policies are important to the portrayal of the Company’s financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, the fair value of other real estate owned, servicing rights and the accounting for deferred income taxes. The Company’s accounting policies are discussed in detail in Note 1 of the Notes to Consolidated Financial Statements included in Item 8., “Financial Statements and Supplementary Data” of this Form 10-K.

Allowance for Loan Loss. The allowance for loan losses is the amount estimated by management as necessary to cover losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. Determining the amount of the allowance for loan losses necessarily involves a high degree of judgment. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions and other factors related to the collectability of the loan portfolio. Although the Company believes that use of the best information available to establish the allowance for loan losses, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. As new products are added, the complexity of the loan portfolio is increased, and expanded market area, the Company intends to enhance and adapt the methodology to keep pace with the size and complexity of the loan portfolio. Changes in any of the above factors could have a significant effect on the calculation of the allowance for loan losses in any given period. Management believes that its systematic methodology continues to be appropriate given the Company’s size and level of complexity.

Other Real Estate Owned. Property acquired by foreclosure or deed in lieu of foreclosure is recorded at fair value, less cost to sell. Development and improvement costs relating to the property are capitalized. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts that will ultimately be realized from the sale of other real estate owned may differ substantially from the carrying value of the assets because of market factors beyond the Company’s control or because of changes in management’s strategies for recovering the investment.

Servicing Rights. Servicing assets are recognized as separate assets when rights are acquired through the purchase or through the sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as a recovery and an increase to income. Capitalized servicing rights are stated separately on the consolidated balance sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Income Taxes. Income taxes are reflected in the Company's consolidated financial statements to show the tax effects of the operations and transactions reported in the consolidated financial statements and consist of taxes currently payable plus deferred taxes. Accounting Standards Codification, ASC 740, "Accounting for Income Taxes," requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities. They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating the deferred tax asset, the Company is required to estimate income and taxes in the jurisdiction in which the Company operates. This process involves estimating the actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for loan losses, for tax and financial reporting purposes.

Deferred tax assets are deferred tax liabilities attributable to deductible temporary differences and carryforwards. After the deferred tax asset has been measured using the applicable enacted tax rate and provisions of the enacted tax law, it is then necessary to assess the need for a valuation allowance. A valuation allowance is needed when, based on the weight of the available evidence, it is more likely than not that some portion of the deferred tax asset will not be realized. As required by GAAP, available evidence is weighted heavily on cumulative losses with less weight placed on future projected profitability. Realization of the deferred tax asset is dependent on whether there will be sufficient future taxable income of the appropriate character in the period during which deductible temporary differences reverse or within the carryback and carryforward periods available under tax law. As of December 31, 2014, the Company had a net deferred tax liability of $809,000, and determined that no valuation allowance was required. As of December 31, 2013, the Company had net deferred tax assets of $816,000, and determined that no valuation allowance was required.

Our Business and Operating Strategy and Goals

The Company's primary objective is to operate 1st Security Bank of Washington as a well capitalized, profitable, independent, community-oriented financial institution, serving customers in its primary market area defined generally as the greater Puget Sound market area. The Company's strategy is to provide innovative products and superior service to small businesses, industry and geographic niches, and individuals located in its primary market area. Services are currently provided to communities through the main office and seven full-service banking centers. These banking centers are supported with 24/7 access to on-line banking and participation in a worldwide ATM network.

The Company focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. The Board of Directors seeks to accomplish the Company's objectives through the adoption of a strategy designed to improve profitability and maintain a strong capital position and high asset quality. This strategy primarily involves:

Growing and diversifying the loan portfolio and revenue streams. The Company intends to transition lending activities from a predominantly consumer-driven model to a more diversified consumer and business model by emphasizing three key lending initiatives: expansion of commercial business lending programs, increasing in-house originations of residential mortgage loans, primarily for sale into the secondary market, through the mortgage banking program; and commercial real estate lending. Additionally, the Company will seek to diversify the loan portfolio by increasing lending to small businesses in the market area, as well as residential construction lending.

Maintaining and improving asset quality. The Company believes that strong asset quality is a key to long-term financial success. The percentage of non-performing loans to total loans was 0.1% at December 31, 2014, down from 0.4% at December 31, 2013. The Company’s percentage of non-performing assets to total assets at December 31, 2014 and 2013 was flat at 0.08%. The Company has actively managed the delinquent loans and non-performing assets by aggressively pursuing the collection of consumer debts and marketing saleable properties upon which were foreclosed or repossessed, work-outs of classified assets and loan charge-offs. In the past several years, the Company also began emphasizing consumer loan originations to borrowers with higher credit scores, generally credit scores over 720 (although the policy allows us to go lower), which has led to lower charge-offs in recent periods. Although the Company intends to grow the loan portfolio by expanding commercial real estate and commercial business lending, the Company intends to manage credit exposures through the use of experienced bankers in this area and a conservative approach to lending.

Emphasizing lower cost core deposits to reduce the costs of funding loan growth. The Company offers personal and business checking accounts, NOW accounts and savings and money market accounts, which generally are lower-cost sources of funds than certificates of deposit, and are less sensitive to withdrawal when interest rates fluctuate. In order to build a core deposit base, the Company is pursuing a number of strategies. First, a diligent attempt to recruit all commercial loan customers to maintain a deposit relationship with the Company, generally a business checking account relationship to the extent practicable, for the term of their loan. Second, interest rate promotions are provided on savings and checking accounts from time to time to encourage the growth of these types of deposits.

Capturing customers' full relationship. The Company offers a wide range of products and services that provide diversification of revenue sources and solidify the relationship with the Bank's customers. The Company focuses on core retail and business deposits, including savings and checking accounts, that lead to long-term customer retention. As part of the commercial lending process cross-selling the entire business banking relationship, including deposit relationships and business banking products, such as online cash management, treasury management, wires, direct deposit, payment processing and remote deposit capture. The Company's mortgage banking program also provides opportunities to cross-sell products to new customers.

Expanding the Company's markets. In addition to deepening relationships with existing customers, the Company intends to expand business to new customers by leveraging the Company's well-established involvement in the community and by selectively emphasizing products and services designed to meet their banking needs. The Company also intends to pursue expansion in other market areas through selective growth of the home lending network. As an example, the Company added a home lending team in the Tri-Cities area of Washington State in the fourth quarter of 2014 due to a long standing working relationship with the manager of its recently opened loan production office. The Company may also consider the acquisition of other financial institutions or branches of other banks in the Puget Sound market area although currently no specific transactions are planned.

Comparison of Financial Condition at December 31, 2014 and December 31, 2013

Assets. Total assets increased $90.6 million, or 21.6%, to $509.8 million at December 31, 2014, from $419.2 million at December 31, 2013, primarily the result of an increase in loans receivable, net of $106.1 million, and loans held for sale of $14.8 million, partially offset by decreases in total cash and cash equivalents of $21.0 million, securities available for sale of $7.5 million, and OREO of $2.1 million.

Loans receivable, net, increased $106.1 million, or 37.7%, to $387.2 million at December 31, 2014, from $281.1 million at December 31, 2013. The increase in loans receivable, net was primarily a result of increases in commercial business loans of $28.6 million, one-to-four-family loans of $26.0 million, construction and development loans of $16.2 million, consumer loans of $14.1 million, multi-family loans of $11.5 million, and commercial loans of $10.0 million. The increase in commercial business loans of $28.6 million, or 58.2%, to $77.9 million at December 31, 2014, from $49.2 million at December 31, 2013, was due in part to increases in the utilization of warehouse lending lines of credit. As of December 31, 2014, there was $10.1 million in warehouse lines outstanding, compared to $4.0 million outstanding at December 31, 2013. The warehouse lending business is closely correlated with home lending interest rates and as home lending rates decreased in the last quarter of 2014, refinancing activity increased when compared to 2013 year end.

A portion of the California originated solar loans totaling $9.1 million were sold in the fourth quarter of 2014. The sale resulted in a pre-tax gain of $377,000, or 4.1% of the amount sold.

One-to-four-family originations of loans held for sale, including loans brokered to other institutions, increased 20.3% to $288.4 million during the year ended December 31, 2014, compared to $239.8 million for the prior year. The increase in originations is as a result of new production staff hired in the third and fourth quarter of 2014 and a favorable reduction in market interest rates. During the year ended December 31, 2014, the Company sold $263.2 million of one-to-four-family mortgage loans compared to sales of $239.5 million during the year ended December 31, 2013.

The Company's allowance for loan losses at December 31, 2014, was $6.1 million, or 1.5% of gross loans receivable, compared to $5.1 million, or 1.8% of gross loans receivable, at December 31, 2013. Growth in loan balances partially offset by improved asset quality was the primary reason for increases in the allowance.

Non-performing loans, consisting of non-accruing loans and accruing loans more than 90 days delinquent, decreased $668,000, or 60.7%, to $433,000 at December 31, 2014, from $1.1 million at December 31, 2013. At December 31, 2014, the Company's non-performing loans consisted of $299,000 of consumer loans, $73,000 of one-to-four-family loans, and $61,000 of home equity loans. Non-performing loans to total loans decreased to 0.1% at December 31, 2014, from 0.4% at December 31, 2013. There was no other real estate owned as of December 31, 2014, compared to $2.1 million at December 31, 2013.

At December 31, 2014, the Company also had $783,000 in restructured loans, of which all were performing in accordance with their revised terms and returned to accrual status. See Item 1., "Business – Lending Activities – Asset Quality" of this Form 10-K for additional information regarding the Company's non-performing loans.

Liabilities. Total liabilities increased $87.0 million, or 24.4%, to $443.9 million at December 31, 2014, from $356.9 million at December 31, 2013, primarily due to an $83.6 million increase in deposits. The increase in deposits was due to a $33.4 million, or 28.1% increase in money market accounts, $30.1 million, or 23.2%, increase in certificate of deposit accounts, a $13.8 million, or 19.0%, increase in noninterest-bearing and interest-bearing checking accounts, and a $6.2 million, or 40.5%, increase in savings accounts. The increase in deposits was due primarily to management's direct marketing of transactional accounts to its existing customer base as part of its continued focus on core deposits. Relationship-based transactional deposits increased $13.8 million from $72.5 million at December 31, 2013.

The Company's total borrowings, which consist of FHLB advances, increased $370,000, or 2.2%, to $17.0 million at December 31, 2014, from $16.7 million at December 31, 2013. The increase in borrowings was primarily related to managing the Company's long-term interest rate risk.

Equity. Total stockholders' equity increased $3.5 million, or 5.7%, to $65.8 million at December 31, 2014, from $62.3 million at December 31, 2013. The increase in stockholders' equity from December 31, 2013, was primarily as a result of net income of $4.5 million, and an increase of $1.0 million in accumulated other comprehensive income representing a decrease in the unrealized loss on securities available for sale due to a decrease in Treasury rates, and the sale of some of the Company's longer term bonds to reduce the exposure to longer term rates, partially offset by $2.2 million of common stock share repurchases and $704,000 of dividends paid.

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Average Balances, Interest and Average Yields/Cost

The following table sets forth for the periods indicated, information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resultant yields, interest rate spread, net interest margin (otherwise known as net yield on interest earning assets), and the ratio of average interest-earning assets to average interest-bearing liabilities. Also presented is the weighted average yield on interest-earning assets, rates paid on interest-bearing liabilities and the resultant spread at December 31, 2014. Income and all average balances are monthly average balances. Non-accruing loans have been included in the table as loans carrying a zero yield.

	At December 31,	Years Ended December 31,								
	2014	2014			2013			2012		
	Yield/ Rate	Average Balance Outstanding	Interest Earned Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned Paid	Yield/ Rate	Average Balance Outstanding	Interest Earned Paid	Yield/ Rate
	(Dollars in thousands)									
Interest-earning assets:										
Loans receivable, net [1]	6.56 %	$333,093	$22,930	6.88 %	$283,107	$20,264	7.16 %	$244,680	$17,908	7.32 %
Loans held for sale	3.89	20,699	685	3.31	13,778	527	3.82	3,666	149	4.06 %
Mortgage-backed securities	2.03	27,314	534	1.96	21,668	390	1.80	16,863	321	1.90
Investment securities	2.11	30,449	618	2.03	24,866	480	1.93	18,749	363	1.94
FHLB stock	0.30	1,733	2	0.12	1,738	1	0.06	1,792	—	—
Other[2]	0.54	19,446	73	0.38	21,397	71	0.33	16,780	46	0.27
Total interest-earning assets [1]	5.66 %	432,734	24,842	5.74 %	366,554	21,733	5.93 %	302,530	18,787	6.21 %
Interest-bearing liabilities:										
Savings and money market	0.54 %	142,967	609	0.43 %	130,545	535	0.41 %	122,689	585	0.48 %
Interest-bearing checking	0.09	27,123	28	0.10	23,257	34	0.15	21,406	52	0.24
Certificates of deposit	1.28	144,476	1,797	1.24	112,305	1,409	1.25	99,653	1,571	1.58
Borrowings	1.30	22,714	268	1.18	16,451	200	1.22	7,642	155	2.03
Total interest-bearing liabilities	0.86 %	337,280	2,702	0.80 %	282,558	2,178	0.77 %	251,390	2,363	0.94 %
			$22,140			$19,555			$16,424	

Net interest income							
Net interest rate spread	4.80 %		4.94 %		5.16 %		5.27 %
Net earning assets		$95,454		$83,996		$51,140	
Net interest margin	N/A		5.12 %		5.33 %		5.43 %
Average interest-earning assets to average interest-bearing liabilities		128.30 %		129.73 %		115.43 %	

(1) The average loans receivable, net balances include non-accruing loans.
(2) Includes interest-bearing deposits at other financial institutions.

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Rate/Volume Analysis

The following table presents the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. It distinguishes between the changes related to outstanding balances and that due to the changes in interest rates. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (i.e., changes in volume multiplied by old rate) and (ii) changes in rate (i.e., changes in rate multiplied by old volume). For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the change due to volume and the change due to rate.

	Years Ended December 31, 2014 vs. 2013			Years Ended December 31, 2013 vs. 2012		
	Increase (Decrease) Due to		Total Increase (Decrease)	Increase (Decrease) Due to		Total Increase (Decrease)
	Volume	Rate		Volume	Rate	
	(In thousands)					
Interest-earning assets:						
Loans receivable, net[1]	$3,578	$(912)	$2,666	$2,812	$(456)	$2,356
Loans held for sale	265	(107)	158	411	(33)	378
Mortgage-backed securities	102	42	144	91	(22)	69
Investment securities	108	30	138	118	(1)	117
FHLB stock	—	1	1	—	1	1
Other[2]	(6)	8	2	13	12	25
Total interest-earning assets[1]	$4,047	$(938)	3,109	$3,445	$(499)	2,946
Interest-bearing liabilities:						
Savings and money market	$51	$23	$74	$37	$(87)	$(50)
Interest-bearing checking	6	(12)	(6)	4	(22)	(18)
Certificates of deposit	404	(16)	388	199	(361)	(162)
Borrowings	76	(8)	68	179	(134)	45
Total interest-bearing liabilities	$537	$(13)	524	$419	$(604)	(185)
Net change in interest income			$2,585			$3,131

(1) The average loans receivable, net balances include non-accruing loans.
(2) Includes interest-bearing deposits at other financial institutions.

Comparison of Results of Operations for the Years Ended December 31, 2014 and 2013

General. Net income for the year ended December 31, 2014, increased $620,000 to $4.5 million, compared to $3.9 million for the year ended December 31, 2013. The provision for loan losses decreased $370,000, or 17.1%, during the year ended December 31, 2014, compared to the prior year end.

Net Interest Income. Net interest income before the provision for loan losses increased $2.6 million to $22.1 million for the year ended December 31, 2014, compared to $19.5 million for the year ended December 31, 2013. The increase in net interest income was primarily attributable to a $2.7 million increase in loan receivable interest income resulting from a $50.0 million increase in average loans receivable over the last year partially offset by a $524,000 increase in interest expense, primarily due to increases in the average balances of interest-bearing deposits and borrowings as compared to the same period last year.

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The Company’s net interest margin ("NIM") decreased 21 basis points to 5.12% for the year ended December 31, 2014, from 5.33% for the prior year. The reduced NIM reflects growth in lower yielding loan types as part of the loan diversification strategy instituted with the three year business plan. The loan diversification strategy will continue to pressure the NIM as real estate and business loans have a lower yield than consumer loan products. As a percentage, consumer loans to total loans were 34.7% as of December 31, 2014, compared to 42.7% as of December 31, 2013. The reduced NIM reflects the increase in average interest earning assets during the period, including increased lower yielding cash and cash equivalents and investment securities available to fund projected loan growth. Diversified loan growth continues to pressure the NIM as real estate and business loans have a lower yield than consumer loan products. The cost of average interest-bearing liabilities increased three basis points to 0.80% for the year ended December 31, 2014, compared to 0.77% for the prior year primarily due to a $32.2 million increase in the average balance of certificates of deposit as a result of promotions during the current year.

Interest Income. Total interest income for the year ended December 31, 2014, increased $3.1 million, or 14.3%, to $24.8 million, from $21.7 million for the year ended December 31, 2013. The increase during the year was primarily attributable to an increase in the average balance of net loans receivable over the last year to $333.1 million for the year ended December 31, 2014, compared to $283.1 million for the year ended December 31, 2013, partially offset by a 19 basis point decline in the average yield on interest-earning assets to 5.74% during the year ended December 31, 2014, from 5.93% for last year.

The following table compares average earning asset balances, associated yields, and resulting changes in interest income for the years ended December 31, 2014 and 2013:

	Years Ended December 31,						
	2014			2013			
	Average Balance Outstanding	Yield		Average Balance Outstanding	Yield		Increase in Interest Income
	(Dollars in thousands)						
Loans receivable, net[1]	$333,093	6.88	%	$283,107	7.16	%	$2,666
Loans held for sale	20,699	3.31		13,778	3.82		158
Mortgage-backed securities	27,314	1.96		21,668	1.80		144
Investment securities	30,449	2.03		24,866	1.93		138
FHLB stock	1,733	0.12		1,738	0.06		1
Cash and due from banks[2]	19,446	0.38		21,397	0.33		2
Total interest-earning assets	$432,734	5.74	%	$366,554	5.93	%	$3,109

(1) The average loans receivable, net balances include non-accruing loans.
(2) Includes interest-bearing deposits at other financial institutions.

Interest Expense. Interest expense increased $524,000, or 24.1%, to $2.7 million for the year ended December 31, 2014, from $2.2 million for the year ended December 31, 2013. As a result of general market rate decreases, and promotion driven increases in certificates of deposits and money market account balances, the average cost of funds for total interest-bearing liabilities increased three basis points to 0.80% for the year ended December 31, 2014, compared to 0.77% for the year ended December 31, 2013. The average balance of total interest-bearing liabilities increased $54.7 million, or 19.4%, to $337.3 million for the year ended December 31, 2014, from $282.6 million for the year ended December 31, 2013.

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The following table details average balances for cost of funds and the change in interest expense for the years ended December 31, 2014 and 2013:

	Years Ended December 31,				
	2014		2013		
	Average Balance Outstanding	Yield	Average Balance Outstanding	Yield	Increase (Decrease) in Interest Expense
	(Dollars in thousands)				
Savings and money market	$142,967	0.43 %	$130,545	0.41 %	$74
Interest-bearing checking	27,123	0.10	23,257	0.15	(6)
Certificates of deposit	144,476	1.24	112,305	1.25	388
Borrowings	22,714	1.18	16,451	1.22	68
Total interest-bearing liabilities	$337,280	0.80 %	$282,558	0.77 %	$524

Provision for Loan Losses. In connection with its analysis of the loan portfolio for the year ended December 31, 2014, management determined that a provision for loan losses of $1.8 million was required for the year ended December 31, 2014, compared to a provision for loan losses of $2.2 million established for the year ended December 31, 2013. The $370,000 decrease in the provision primarily relates to the decrease in non-accrual loans and net charge-offs during the year. Non-performing loans were $433,000, or 0.1% of total gross loans at December 31, 2014, compared to $1.1 million, or 0.4% of total gross loans at December 31, 2013. During the year ended December 31, 2014, net charge-offs totaled $802,000 compared to $1.8 million during the year ended December 31, 2013. Management considers the allowance for loan losses at December 31, 2014, to be adequate to cover probable losses inherent in the loan portfolio based on the assessment of the above-mentioned factors affecting the loan portfolio. While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the Company’s financial condition and results of operations. In addition, the determination of the amount of allowance for loan losses is subject to review by bank regulators, as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

The following table details activity and information related to the allowance for loan losses for the years ended December 31, 2014 and 2013:

	At or For the Years Ended December 31,	
	2014	2013
	(Dollars in thousands)	
Provision for loan losses	$1,800	$2,170
Net charge-offs	$802	$1,776
Allowance for loan losses	$6,090	$5,092
Allowance for loan losses as a percentage of total gross loans receivable at the end of the year	1.5 %	1.8 %
Non-accrual and 90 days or more past due loans	$433	$1,101

Allowance for loan losses as a percentage of non-performing loans at end of year	1,406.5 %	462.5 %
Non-accrual and 90 days or more past due loans as a percentage of gross loans receivable at the end of the year	0.1 %	0.4 %
Total gross loans	$394,210	$287,216

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Noninterest Income. Noninterest income increased $1.1 million, or 12.5%, to $10.0 million for the year ended December 31, 2014, from $8.9 million for the year ended December 31, 2013. The following table provides a detailed analysis of the changes in the components of noninterest income:

	Years Ended December 31,		Increase (Decrease)	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Service charges and fee income	$1,762	$1,807	$(45)	(2.5)%
Gain on sale of loans	7,577	6,371	1,206	18.9
Gain on sale of investment securities	(41)	264	(305)	(115.5)
Impairment loss on long-lived assets	(9)	—	(9)	—
Other noninterest income	744	473	271	57.3
Total noninterest income	$10,033	$8,915	$1,118	12.5 %

The $1.2 million increase in gain on sale of loans was primarily a result of additional gains associated with the sale of mortgage loans to the secondary market as part of the Company's mortgage lending operations. The $271,000 increase in other noninterest income was primarily due to a $203,000 increase in brokered loan fees.

Noninterest Expense. Noninterest expense increased $3.5 million, or 17.4%, to $23.9 million for the year ended December 31, 2014, compared to $20.4 million for the year ended December 31, 2013. The following table provides an analysis of the changes in the components of noninterest expense:

	Years Ended December 31,		Increase (Decrease)	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Salaries and benefits	$14,064	$10,886	$3,178	29.2 %
Operations	3,479	3,026	453	15.0
Occupancy	1,655	1,549	106	6.8
Data processing	1,315	1,105	210	19.0
OREO fair value write-downs, net of loss on sales	42	518	(476)	(91.9)
OREO expenses	9	132	(123)	(93.2)
Loan costs	1,346	1,336	10	0.7
Professional and board fees	1,236	1,193	43	3.6
FDIC insurance	254	251	3	1.2
Marketing and advertising	520	474	46	9.7
Recovery of loss on servicing rights	(18)	(109)	91	(83.5)
Total noninterest expense	$23,902	$20,361	$3,541	17.4 %

Salaries and benefits increased $3.2 million, or 29.2%, to $14.1 million for the year ended December 31, 2014, from $10.9 million for the prior year, primarily as a result of the hiring of additional employees in mortgage-related lending, and loan serving and operations areas and increased commissions and incentive compensation associated with the Company’s loan growth and the implementation of the equity incentive plan. Commission based expenses increased $765,000, or 35.3% to $2.9 million during 2014 as a direct result of the growth in the Company's mortgage lending operations and residential construction lending. At December 31, 2014, the Company employed 209 full-time equivalent employees compared to 158 at December 31, 2013. Operations expense increased $453,000, or 15.0% partially due to an increase in costs associated with increased staff, new lending programs, and excise taxes. Occupancy

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expense increased $106,000, or 6.8%, primarily as a result of opening a new home lending office location, and adding additional employees at the corporate office location. Marketing and advertising fees increased $46,000, or 9.7%, related primarily to increased product advertising and brand awareness. Partially offsetting these increases were decreases in OREO fair value write-downs of $476,000, or 91.9%, and OREO expenses of $123,000, or 93.2%, during the current year.

The efficiency ratio, which is the percentage of noninterest expense to net interest income plus noninterest income, was 74.3% for the year ended December 31, 2014, compared to 71.5% for the year ended December 31, 2013. The deterioration in the efficiency ratio was primarily attributable to an increase in salaries and benefits under noninterest expense. By definition, a lower efficiency ratio would be an indication that the Company is more efficiently utilizing resources to generate income.

Provision for Income Tax. During the year ended December 31, 2014, the Company recorded a provision for income tax expense of $1.9 million on pre-tax income compared to $2.0 million for the year ended December 31, 2013. The effective tax rate for the year ended December 31, 2014, was 29.8% compared to 34.0% for the year ended December 31, 2013. As of December 31, 2014, there was no net deferred tax asset, and the net deferred tax liability was $809,000. As of December 31, 2013, the net deferred tax asset was $816,000.

Asset and Liability Management and Market Risk

Risk When Interest Rates Change. The rates of interest the Company earns on assets and pays on liabilities generally is established contractually for a period of time. Market rates change over time. Like other financial institutions, the Company’s results of operations are impacted by changes in interest rates and the interest rate sensitivity of the Company’s assets and liabilities. The risk associated with changes in interest rates and the Company’s ability to adapt to these changes is known as interest rate risk and is the most significant market risk.

How The Company Measures Risk of Interest Rate Changes. As part of an attempt to manage exposure to changes in interest rates and comply with applicable regulations, the Company monitors interest rate risk. In doing so, the Company analyzes and manages assets and liabilities based on their interest rates and payment streams, timing of maturities, repricing opportunities, and sensitivity to actual or potential changes in market interest rates.

The Company is subject to interest rate risk to the extent that its interest-bearing liabilities, primarily deposits and FHLB advances, reprice more rapidly or at different rates than the interest-earning assets. In order to minimize the potential for adverse effects of material prolonged increases or decreases in interest rates on the Company’s results of operations, the Company has adopted an Asset and Liability Management Policy. The Board of Directors sets the Asset and Liability Management Policy for the Bank, which is implemented by the asset/liability committee (“ALCO”), an internal management committee. The board level oversight for ALCO is performed by the audit committee of the Board of Directors.

The purpose of the ALCO is to communicate, coordinate, and control asset/liability management consistent with the business plan and board-approved policies. The committee establishes and monitors the volume and mix of assets and funding sources, taking into account relative costs and spreads, interest rate sensitivity and liquidity needs. The objectives are to manage assets and funding sources to produce results that are consistent with liquidity, capital adequacy, growth, risk and profitability goals.

The committee generally meets monthly to, among other things, protect capital through earnings stability over the interest rate cycle; maintain the Bank’s well capitalized status; and provide a reasonable return on investment. The committee recommends appropriate strategy changes based on this review. The committee is responsible for reviewing and reporting the effects of the policy implementations and strategies to the Board of Directors at least quarterly. The Chief Financial Officer oversees the process on a daily basis.

A key element of the Bank's asset/liability management plan is to protect net earnings by managing the maturity or repricing mismatch between interest-earning assets and rate-sensitive liabilities. The Company seeks to accomplish this by extending funding maturities through wholesale funding sources, including the use of FHLB advances and brokered certificates of deposit, and through asset management, including the use of adjustable-rate loans and selling certain fixed-rate loans in the secondary market. Management is also focused on matching deposit duration with the duration of earning assets as appropriate.

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As part of the efforts to monitor and manage interest rate risk, a number of indicators are used to monitor overall risk. Among the measurements are:

Market Risk. Market risk is the potential change in the value of investment securities if interest rates change. This change in value impacts the value of the Company and the liquidity of the securities. Market risk is controlled by setting a maximum average maturity/average life of the securities portfolio to 10 years.

Economic Risk. Economic risk is the risk that the underlying value of a bank will change when rates change. This can be caused by a change in value of the existing assets and liabilities (this is called Economic Value of Equity or EVE), or a change in the earnings stream (this is caused by interest rate risk). The Company takes economic risk primarily when fixed rate loans are made, or purchase fixed-rate investments, or issue long term certificates of deposit or take fixed-rate FHLB advances. It is the risk that interest rates will change and these fixed-rate assets and liabilities will change in value. This change in value usually is not recognized in the earnings, or equity (other than marking to market securities available-for-sale or fair value adjustments on loans held for sale). The change is recognized only when the assets and liabilities are liquidated. Although the change in market value is usually not recognized in earnings or in capital, the impact is real to the long-term value of 1st Security Bank of Washington. Therefore, the Company will control the level of economic risk by limiting the amount of long-term, fixed-rate assets the Company will have and by setting a limit on concentrations and maturities of securities.

Interest Rate Risk. If the Federal Reserve Board changes the Federal Funds rate 100, 200 or 300 basis points, the Bank policy dictates that a change in net interest income should not change more that 7.5%, 15% and 30%, respectively.

The table presented below, as of December 31, 2014, is an analysis prepared for 1st Security Bank of Washington by Olson Research Associates, Inc. utilizing various market and actual experience-based assumptions. The table represents a static shock to the net interest income using instantaneous and sustained shifts in the yield curve, in 100 basis point increments, up and down 100 basis points. Given the low interest rate environment reduction in rates by 200 and 300 basis points are not reported. The results reflect a projected income statement with minimal exposure to instantaneous changes in interest rates. These results are primarily based upon historical prepayment speeds within the consumer lending portfolio in combination with the above average yields associated with the consumer portfolio if those prepayments do not occur. The current federal funds rate is 0.25% making a 200 and 300 basis point decrease impossible.

Change in Interest Rates in Basis Points	December 31, 2014 Net Interest Income Amount	Change	Change
	(Dollars in thousands)		
300bp	$28,481	$1,353	4.99 %
200bp	28,138	1,011	3.73
100bp	27,653	525	1.94
0bp	27,127	—	—
(100)bp	25,786	(1,341)	(4.94)

In managing the assets/liability mix the Company typically places an equal emphasis on maximizing net interest margin and matching the interest rate sensitivity of the assets and liabilities. From time to time, however, depending on the relationship between long- and short-term interest rates, market conditions and consumer preference, the Company may place somewhat greater emphasis on maximizing net interest margin than on strictly matching the interest rate sensitivity of the assets and liabilities. Management also believes that the increased net income which may result from an acceptable mismatch in the actual maturity or repricing of the asset and liability portfolios can, during periods of declining or stable interest rates, provide sufficient returns to justify the increased exposure to sudden and unexpected increases in interest rates which may result from such a mismatch. Management believes that

1st Security Bank of Washington's level of interest rate risk is acceptable under this approach.

In evaluating 1st Security Bank of Washington's exposure to interest rate movements, certain shortcomings inherent in the method of analysis presented in the foregoing table must be considered. For example, although certain assets and liabilities may have similar maturities or repricing periods, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in interest rates. Additionally, certain assets, such as adjustable rate mortgages, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a significant change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed above. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. 1st Security Bank of Washington considers all of these factors in monitoring its exposure to interest rate risk.

Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit run-off that may occur in the normal course of business. The Company relies on a number of different sources in order to meet potential liquidity demands. The primary sources are increases in deposit accounts, FHLB advances, cash flows from loan payments and maturing securities, and sales of one-to-four-family mortgages and consumer loans.

As of December 31, 2014, the Bank's total borrowing capacity was $57.6 million with the FHLB of Seattle, with unused borrowing capacity of $57.6 million at that date. In addition to the availability of liquidity from the FHLB of Seattle, the Bank maintained a short-term borrowing line, with a current limit of $69.6 million at December 31, 2014, with the Federal Reserve Bank. As of December 31, 2014, $17.0 million in FHLB advances were outstanding and no advances were outstanding against the Federal Reserve Bank line of credit. Our borrowing capacity is subject to certain collateral requirements in accordance with the borrowing agreements. The Bank maintains a short-term borrowing line with the San Francisco FRB with total credit based on eligible collateral. The Bank can borrow under the Term Auction or Term Facility at rates published by the San Francisco FRB. As of December 31, 2014 and 2013, the Bank had a Term Auction or Term Facility borrowing capacity of $69.6 million and $75.3 million, respectively, of which none was outstanding. The Bank also had a $35.0 million unsecured Fed Funds line of credit with other large financial institutions of which none was outstanding at December 31, 2014. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or $80.4 million as of December 31, 2014. Total brokered deposits as of December 31, 2014 were $19.1 million.

Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in short-term investments, such as overnight deposits, loans held for sale and federal funds. On a longer term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and federal agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At December 31, 2014, the approved outstanding loan commitments, including unused lines of credit, amounted to $162.3 million. Certificates of deposit scheduled to mature in one year or less at December 31, 2014, totaled $53.7 million. It is management's policy to offer deposit rates that are competitive with other local financial institutions. Based on this management strategy, the Company believes that a majority of maturing deposits will remain with 1st Security Bank of Washington.

As further detailed on the Consolidated Statements of Cash Flows, included in Item 8., "Financial Statements and Supplementary Data," of this Form 10-K, for the year ended December 31, 2014, cash and cash equivalents decreased $22.9 million, or 59.6%, from $38.5 million as of December 31, 2013 to $15.6 million as of December 31, 2014. Cash used in operating activities of $4.0 million and cash used in investing activities of $99.9 million were partially funded by cash from financing activities of $81.0 million for the year ended December 31, 2014. Primary sources of cash included $6.6 million from sale of loans held for sale, a $83.6 million increase in deposits, $12.4 million from sales, maturities and calls on investment securities and $21.9 million from the sale of portfolio loans. The sources of cash

were partially offset by $268.5 million in loans held for sale originated, $130.1 million of portfolio loans originated, net of principal collections, $26.4 million in purchases of investment securities.
FS Bancorp is a separate legal entity from 1st Security Bank of Washington and must provide for its own liquidity and pay its own operating expenses. Sources of capital and liquidity for FS Bancorp include distributions from 1st Security Bank of Washington and the issuance of debt or equity securities, although there are regulatory restrictions on the ability of the 1st Security Bank of Washington to pay dividends.
Off-Balance Sheet Activities

In the normal course of operations, 1st Security Bank of Washington engages in a variety of financial transactions that are not recorded in the Company's consolidated financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of loan commitments and lines of credit. For the year ended December 31, 2014, the Company engaged in no off-balance sheet transactions likely to have a material effect on the Company's financial condition, results of operations or cash flows.
A summary of off-balance sheet commitments to extend credit at December 31, 2014 was as follows:

Off-balance sheet loan commitments:	(In thousands)
Real estate secured	$88,095
Commercial business loans	54,664
Home equity loans and lines of credit	13,735
Consumer loans	5,832
Total loan commitments	$162,326

Capital Resources

At December 31, 2014, the Company's equity totaled $65.8 million. Management monitors the capital levels of the Company and the Bank to provide for current and future business opportunities and to meet regulatory capital guidelines. FS Bancorp is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the BHCA, and the regulations of the Federal Reserve. 1st Security Bank of Washington as a state-chartered, federally insured savings bank is subject to minimum capital requirements imposed by the FDIC.
The capital adequacy requirements are quantitative measures established by regulation that require FS Bancorp and 1st Security Bank of Washington to maintain minimum amounts and ratios of capital. Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Through December 31 2014, FDIC regulations required 1st Security Bank of Washington to maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 4.0%, (ii) a ratio of Tier 1 risk-based capital to risk weighted assets of at least 4.0% and (iii) a ratio of total risk-based capital to risk weighted assets of at least 8.0%. Effective January 1, 2015, FDIC regulations require insured state-chartered banks to maintain (i) a minimum ratio of Tier 1 capital to total assets of 4.00%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.00%, (iii) a minimum ratio of total-capital to risk-weighted assets of 8.00% and (iv) a minimum ratio of "Common Equity Tier 1 Capital" to risk-weighted assets of 4.50%.

For a bank holding company with less than $500 million in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. Legislation was enacted in December 2014 which requires the Federal Reserve to amend its "Small Bank Holding Company" Policy Statement to extend the applicability to bank and savings and loan holding companies of up to $1 billion in assets. That will exempt such holding companies from the consolidated holding company capital requirements. Although the Company is currently within the asset size threshold, it is uncertain when the FRB will act and whether the Company would qualify for the exemption under other conditions that may apply. If the Company were subject to regulatory guidelines for bank holding companies with $500 million or more in assets, at December 31, 2014 the Company would have exceeded all regulatory capital requirements. The estimated regulatory

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capital ratios calculated for the Company as of December 31, 2014 were 13.2% for Tier 1 leverage-based capital, 15.8% for Tier 1 risk-based capital and 17.1% for total risk-based capital.

Consistent with the goals to operate a sound and profitable organization, the Company's policy is for 1st Security Bank of Washington to maintain a "well capitalized" status under the capital categories of the FDIC. Through December 31, 2014, a well capitalized institution had to maintain a minimum ratio of total risk-based capital to risk-weighted assets of at least 10.00%, a minimum ratio of Tier 1 risk-based capital to risk weighted assets of at least 6.00%, a minimum ratio of Tier 1 leverage capital to total assets of at least 5.00% and must not be subject to any written order, agreement or directive requiring it to meet or maintain a specific capital level. As of December 31, 2014, 1st Security Bank of Washington was "well capitalized" under the capital adequacy requirements then in effect. Bank holding companies do not have a "well capitalized" measurement because "well capitalized" only applies to banks.

The following table compares 1st Security Bank of Washington's actual capital amounts at December 31, 2014, to its minimum regulatory capital requirements at that date (dollars in thousands):

	Actual			For Capital Adequacy Purposes			To be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
	(Dollars in thousands)								
As of December 31, 2014									
Total risk-based capital (to risk-weighted assets)	$60,978	14.68	%	$33,223	8.00	%	$41,529	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	$55,770	13.43	%	$16,611	4.00	%	$24,917	6.00	%
Tier 1 leverage capital (to average assets)	$55,770	11.17	%	$19,965	4.00	%	$24,956	5.00	%

Recent Accounting Pronouncements

For a discussion of recent accounting standards, please see Note 1 of the Notes to Consolidated Financial Statements included in Item 8 of this Form 10-K.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises principally from interest rate risk inherent in lending, investing, deposit and borrowings activities. Management actively monitors and manages its interest rate risk exposure. In addition to other risks that are managed in the normal course of business, such as credit quality and liquidity, management considers interest rate risk to be a significant market risk that could potentially have a material effect on the Company's financial condition and result of operations. The information contained in Item 7., "Management's Discussion and Analysis of Financial Condition and Results of Operations - Asset and Liability Management" of this Form 10-K is incorporated herein by reference.

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Item 8. Financial Statements and Supplementary Data

FS BANCORP, INC. AND SUBSIDIARY
INDEX TO FINANCIAL STATEMENTS

Index to Consolidated Financial Statements

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Report of Independent Registered Public Accounting Firm

To the Board of Directors
FS Bancorp, Inc.
Mountlake Terrace, Washington

We have audited the accompanying consolidated balance sheets of FS Bancorp, Inc. and subsidiary (the "Company") as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of the Company’s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining evidence, on a test basis, supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FS Bancorp, Inc. and subsidiary as of December 31, 2014 and 2013, and the results of their operations, and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Moss Adams LLP

Everett, Washington
March 27, 2015

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2014 AND 2013

(In thousands, except share data)

	2014	2013
ASSETS		
Cash and due from banks	$10,799	$1,425
Interest-bearing deposits at other financial institutions	9,299	39,660
Securities available-for-sale, at fair value	48,744	56,239
Loans held for sale, at fair value	25,983	11,185
Loans receivable, net	387,174	281,081
Accrued interest receivable	1,558	1,261
Premises and equipment, net	13,584	13,818
Other real estate owned ("OREO")	—	2,075
Federal Home Loan Bank stock, at cost	1,650	1,702
Deferred tax asset, net	—	816
Bank owned life insurance ("BOLI")	6,556	6,369
Servicing rights, held at the lower of cost or fair value	3,061	2,093
Other assets	1,346	1,463
TOTAL ASSETS	$509,754	$419,187
LIABILITIES		
Deposits		
Noninterest-bearing accounts	$56,734	$45,783
Interest-bearing accounts	363,710	291,093
Total deposits	420,444	336,876
Borrowings	17,034	16,664
Deferred tax liability, net	809	—
Other liabilities	5,631	3,334
Total liabilities	443,918	356,874
COMMITMENTS AND CONTINGENCIES (NOTE 11)		
STOCKHOLDERS' EQUITY		
Preferred stock, $.01 par value; 5,000,000 shares authorized; None issued or outstanding	—	—
Common stock, $.01 par value; 45,000,000 shares authorized; 3,235,625 and 3,240,125 shares issued and outstanding at December 31, 2014, and 2013, respectively	32	32
Additional paid-in capital	29,450	30,097
Retained earnings	38,125	35,215
Accumulated other comprehensive income (loss)	117	(898)
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(1,888)	(2,133)
Total stockholders' equity	65,836	62,313
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$509,754	$419,187

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2014 and 2013

(In thousands, except earnings per share data)

	2014	2013
INTEREST INCOME		
Loans receivable and fees	$23,615	$20,791
Interest and dividends on investment securities, cash and cash equivalents, and interest-bearing deposits at other financial institutions	1,227	942
Total interest and dividend income	24,842	21,733
INTEREST EXPENSE		
Deposits	2,434	1,978
Borrowings	268	200
Total interest expense	2,702	2,178
NET INTEREST INCOME	22,140	19,555
PROVISION FOR LOAN LOSSES	1,800	2,170
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	20,340	17,385
NONINTEREST INCOME		
Service charges and fee income	1,762	1,807
Gain on sale of loans	7,577	6,371
(Loss) gain on sale of investment securities	(41)	264
Impairment loss on long-lived assets	(9)	—
Other noninterest income	744	473
Total noninterest income	10,033	8,915
NONINTEREST EXPENSE		
Salaries and benefits	14,064	10,886
Operations	3,479	3,026
Occupancy	1,655	1,549
Data processing	1,315	1,105
OREO fair value impairments, net of loss on sales	42	518
OREO expenses	9	132
Loan costs	1,346	1,336
Professional and board fees	1,236	1,193
FDIC insurance	254	251
Marketing and advertising	520	474
Recovery of loss on servicing rights	(18)	(109)
Total noninterest expense	23,902	20,361
INCOME BEFORE PROVISION FOR INCOME TAXES	6,471	5,939
PROVISION FOR INCOME TAXES	1,931	2,019
NET INCOME	$4,540	$3,920
Basic earnings per share	$1.52	$1.29
Diluted earnings per share	$1.52	$1.29

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2014 and 2013

(In thousands)

	2014	2013
Net Income	$4,540	$3,920
Other comprehensive gain (loss), net of tax:		
Unrealized gain (loss) on securities available-for-sale:		
Unrealized holding gain (loss) arising during period	1,497	(2,003)
Income tax (provision) benefit related to unrealized gains	(509)	682
Reclassification adjustment for realized losses (gains) included in net income	41	(264)
Income tax (benefit) provision related to reclassification for realized gains	(14)	90
Other comprehensive gain (loss), net of tax	1,015	(1,495)
COMPREHENSIVE INCOME	$5,555	$2,425

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2014 and 2013

(In thousands, except share data)

	Common Stock		Additional		Accumulated Other	Unearned	
	Shares	Amount	Paid-in Capital	Retained Earnings	Comprehensive Income (Loss)	ESOP Shares	Total Equity
BALANCE, January 1, 2013	3,240,125	$32	$29,894	$31,746	$597	$(2,372)	$59,897
Net income	—	—	—	3,920	—	—	3,920
Dividends paid ($0.15 per share)	—	—	—	(451)	—	—	(451)
Other comprehensive loss, net of tax	—	—	—	—	(1,495)	—	(1,495)
ESOP shares allocated	—	—	203	—	—	239	442
BALANCE, December 31, 2013	3,240,125	$32	$30,097	$35,215	$(898)	$(2,133)	$62,313
BALANCE, January 1, 2014	3,240,125	$32	$30,097	$35,215	$(898)	$(2,133)	$62,313
Net income	—	—	—	4,540	—	—	4,540
Dividends paid ($0.22 per share)	—	—	—	(704)	—	—	(704)
Share-based compensation	—	—	483	—	—	—	483
Restricted stock awards	125,105	—	(1)	—	—	—	(1)
Common stock repurchased	(129,605)	—	(1,295)	(926)	—	—	(2,221)
Other comprehensive gain, net of tax	—	—	—	—	1,015	—	1,015
ESOP cash distribution	—	—	(35)	—	—	—	(35)
ESOP shares allocated	—	—	201	—	—	245	446
December 31, 2014	3,235,625	$32	$29,450	$38,125	$117	$(1,888)	$65,836

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2014 and 2013

(In thousands)

	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$4,540	$3,920
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	1,800	2,170
Depreciation, amortization and accretion	2,731	2,222
Compensation expense related to stock options and restricted stock awards	483	—
ESOP compensation expense for allocated shares	446	442
Provision for deferred income taxes	1,102	1,924
Increase in cash surrender value of BOLI	(187)	(369)
Gain on sale of loans and loans held for sale	(6,636)	(5,828)
Gain on sale of portfolio loans, net of reserve	(941)	(543)
Origination of loans held for sale	(277,999)	(242,036)
Proceeds from sale of loans held for sale	268,521	244,007
Loss (gain) on sale of investment securities	41	(264)
Recovery of servicing rights	(18)	(109)
Impairment loss on OREO	42	518
Changes in operating assets and liabilities		
Accrued interest receivable	(297)	(38)
Other assets	(475)	80
Other liabilities	2,820	3
Net cash from (used by) operating activities	(4,027)	6,099
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	20,330	8,786
Maturities, prepayments, sales, and calls	12,426	5,225
Purchases	(26,350)	(29,310)
Proceeds from sale of interest-bearing time certificates	248	—
Loan originations and principal collections, net	(130,063)	(26,593)
Proceeds from sale of portfolio loans	21,853	17,966
Proceeds from sale of OREO	2,478	269
Purchase BOLI	—	(6,000)
Purchase of premises and equipment, net	(873)	(2,070)
Impairment loss on long-lived assets	9	—
FHLB stock purchased	(225)	—
FHLB stock redeemed	277	—
Net cash used by investing activities	(99,890)	(31,727)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	83,568	47,927
Proceeds from borrowings	151,459	104,454
Repayments of borrowings	(151,089)	(94,630)
Dividends paid	(704)	(451)

Common stock repurchased	(2,221)	—
Net cash from financing activities	81,013	57,300
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(22,904)	31,672
CASH AND CASH EQUIVALENTS, beginning of year	38,459	6,787
CASH AND CASH EQUIVALENTS, end of year	$15,555	$38,459

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2014 and 2013

(In thousands)

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$2,700	$2,168
Income taxes	$593	$260
SUPPLEMENTARY DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Change in unrealized gain (loss) on investment securities	$1,539	$(2,267)
Property received in settlement of loans	$445	$735

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 – BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – FS Bancorp, Inc. (the “Company”) was incorporated in September 2011 as the holding company for 1st Security Bank of Washington (the “Bank”) in connection with the Bank's conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based stock owned savings bank with seven branches in suburban communities in the greater Puget Sound area. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals.

Financial Statement Presentation – Amounts presented in the consolidated financial statements and footnote tables are rounded and presented in thousands of dollars except per share amounts. In the narrative footnote discussion, amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above $1.0 million. Amounts below $1.0 million are rounded and presented in to the nearest thousandths. Certain prior year amounts have been reclassified to conform to the 2014 presentation with no change to net income or equity previously reported.

Conversion and change in corporate form – On July 9, 2012, in accordance with a Plan of Conversion (the "Plan") adopted by its Board of Directors and as approved by its depositors and borrower members, 1st Security Bank of Washington (i) converted from a mutual savings bank to a stock savings bank, and (ii) became the wholly-owned subsidiary of FS Bancorp, Inc., a bank holding company registered with the Board of Governors of the Federal Reserve System ("FRB"). In connection with the conversion, the Company issued an aggregate of 3,240,125 shares of common stock at an offering price of $10.00 per share for gross proceeds of $32.4 million. From the proceeds, the Company made a capital contribution of $15.5 million to the Bank. The Bank intends to use this additional capital for future lending and investment activities and for general and other corporate purposes subject to regulatory limitations. The cost of conversion and the issuance of capital stock was approximately $2.5 million, which was deducted from the proceeds of the offering.

Pursuant to the Plan, the Company's Board of Directors adopted an employee stock ownership plan ("ESOP") which purchased 8% of the common stock in the open market or 259,210 shares. As provided for in the Plan, the Company also established a liquidation account in the amount of retained earnings as of December 31, 2011. The liquidation account will be maintained for the benefits of eligible savings account holders as of June 30, 2007 and supplemental eligible account holders as of March 31, 2012 who maintain deposit accounts at the Bank after the conversion. The conversion was accounted for as a change in corporate form with the historic basis of the Company’s assets, liabilities, and equity unchanged as a result.

Use of Estimates – The preparation of financial statements in conformity with generally accepted accounting principles (“GAAP”) in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to change in the near term are allowances for loan losses, fair value of other real estate owned (“OREO”), servicing assets, and the estimated accounting for deferred income taxes.

Principles of consolidation – The consolidated financial statements include the accounts of FS Bancorp and its wholly owned subsidiary, 1st Security Bank of Washington. All material intercompany accounts have been eliminated in consolidation.

Segment Reporting – The Company's major line of business is community banking. Management has determined that the Company operates as a single operating segment based on accounting principles generally accepted in the United States ("GAAP").

Subsequent Events – The Company has evaluated events and transactions subsequent to December 31, 2014, for potential recognition or disclosure.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and Cash Equivalents – Cash and cash equivalents include cash and due from banks, and interest bearing balances due from other banks and the Federal Reserve Bank of San Francisco. Cash and cash equivalents have a maturity of 90 days or less at the time of purchase. As of December 31, 2014 and 2013, the Company had cash deposits at other financial institutions in excess of Federal Deposit Insurance Corporation ("FDIC") insured limits. However, as the Company places these deposits with major financial institutions and monitors the financial condition of these institutions, and has not experienced any losses.

The Company held interest-bearing deposits at other financial institutions with a cost basis of $9.3 million, including $4.7 million at the Federal Reserve Bank ("FRB") and $39.7 million, including $37.0 million at the FRB, as of December 31, 2014 and 2013, respectively. Certificates of deposits in the amount of $4.5 million and $2.6 million, with original maturity dates greater than 90 days were excluded from cash and cash equivalents as of December 31, 2014 and 2013, respectively.

Securities Available-for-Sale – Securities available-for-sale consist of debt securities that the Company has the intent and ability to hold for an indefinite period, but not necessarily to maturity. Such securities may be sold to implement the Company’s asset/liability management strategies and in response to changes in interest rates and similar factors. Securities available-for-sale are reported at fair value. Unrealized gains and losses, net of the related deferred tax effect, are reported as a net amount in a separate component of equity entitled accumulated other comprehensive income. Unrealized losses that are deemed to be other than temporary are reflected in results of operations. Any declines in the values of these securities that are considered to be other-than-temporary-impairment (“OTTI”) and credit-related are recognized in earnings. Noncredit-related OTTI on securities not expected to be sold is recognized in other comprehensive income. The review for OTTI is conducted on an ongoing basis and takes into account the severity and duration of the impairment, recent events specific to the issuer or industry, fair value in relationship to cost, extent and nature of change in fair value, creditworthiness of the issuer including external credit ratings and recent downgrades, trends and volatility of earnings, current analysts’ evaluations, and other key measures. In addition, the Company does not intend to sell the securities and it is more likely than not that we will not be required to sell the securities before recovery of their amortized cost basis. In doing this, we take into account our balance sheet management strategy and consideration of current and future market conditions. Realized gains and losses on securities available-for-sale, determined using the specific identification method, are included in results of operations. Amortization of premium and accretion of discounts are recognized in interest income over the period to maturity.

Federal Home Loan Bank Stock – The Bank, as a member of the Federal Home Loan Bank of Seattle (“FHLB”) system, is required to maintain an investment in capital stock of the FHLB in an amount equal to the greater of 0.5% of its outstanding home loans or 4.5% of advances from the FHLB. The Bank's investment in FHLB stock is carried at par value ($100 per share), which reasonably approximates its fair value. As of December 31, 2014 and 2013, $750,000 and $733,000, respectively, of FHLB stock was pledged as collateral for FHLB advances.

The Bank’s investment in FHLB stock is carried at par value ($100 per share) because the shares can only be redeemed with the FHLB at par. The Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding mortgages and FHLB advances. Stock redemptions are at the discretion of the

FHLB upon five years' prior notice for FHLB Class B stock or six months notice for FHLB Class A stock to the FHLB. FHLB stock is carried at cost and is subject to recoverability testing annually.

Loans Held for Sale – Mortgage loans originated for sale in the foreseeable future in the secondary market are carried at fair value. All sales are made individually without recourse after a 90-day buyback clause for late payments. Net unrealized gains and losses are recognized through a valuation allowance established by charges to income.

The Company issues various representations and warranties associated with the sale of loans. The Company is responsible for any losses taken on loans that did not comply with the representations and warranties made at the time

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

of sale. The Company has not experienced any significant losses during the years ended December 31, 2014 and 2013 regarding these representations and warranties.

Derivatives – The Company regularly enters into commitments to originate and sell loans held for sale. Such commitments are considered derivative instruments. The Company recognizes all derivative instruments as either assets or liabilities in the consolidated balance sheet and measures those instruments at fair value. Changes in fair value are reported in current period income.

The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters into contracts to sell forward To-Be-Announced (TBA) mortgage backed securities - these contracts are considered derivative instruments. These instruments are measured at fair value and are recognized as either an asset or liability on the consolidated balance sheet. Changes in fair value are reported in current period income.

Loans Receivable, Net – Loans receivable, net, are stated at the amount of unpaid principal reduced by an allowance for loan losses and net deferred fees or costs. Interest on loans is calculated using the simple interest method based on the daily balance of the principal amount outstanding and is credited to income as earned. Loan fees, net of direct origination costs, are deferred and amortized over the life of the loan using the effective yield method.

Interest on loans is accrued daily based on the principal amount outstanding. Generally, the accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due or when they are past due 90 days as to either principal or interest (based on contractual terms), unless they are well secured and in the process of collection. All interest accrued but not collected for loans that are placed on non-accrual status or charged off are reversed against interest income. Subsequent collections on a cash basis are applied proportionately to past due principal and interest, unless collectability of principal is in doubt, in which case all payments are applied to principal. Loans are returned to accrual status when the loan is deemed current, and the collectability of principal and interest is no longer doubtful, or, generally, when the loan is less than 90 days delinquent, and performing according to contractual terms after a period of six months performance.

The Company charges fees for originating loans. These fees, net of certain loan origination costs, are deferred and amortized to income, on the level-yield basis, over the loan term. If the loan is repaid prior to maturity, the remaining unamortized net deferred loan origination fee is recognized in income at the time of repayment.

Impaired Loans – A loan is considered impaired when it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the original or modified terms of the loan agreement. Impaired loans are measured based on the estimated fair value of the collateral less estimated cost to sell if the loan is considered collateral dependent. Impaired loans not considered to be collateral dependent are measured based on the present value of expected future cash flows.

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Company considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the collateral value, reasons for delay, payment record, the amount of past due and the number of days past due. Loans that experience insignificant payment delays and payment shortfalls are generally not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the
circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed.

FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses – The allowance for loan losses is maintained at a level considered adequate to provide for probable losses on existing loans based on evaluating known and inherent risks in the loan portfolio. The allowance is reduced by loans charged-off and increased by provisions charged to earnings and recoveries on loans previously charged-off. The allowance is based on management’s periodic, systematic evaluation of factors underlying the quality of the loan portfolio including changes in the size and composition of the loan portfolio, the estimated value of any underlying collateral, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectability may not be assured. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. While management uses the best information available to make its estimates, future adjustments to the allowance may be necessary if there is a significant change in economic and other conditions. The appropriateness of the allowance for loan losses is estimated based on these factors and trends identified by management at the time the financial statements are prepared.

When available information confirms that specific loans or portions thereof are uncollectible, these amounts are charged-off against the allowance for loan losses. The existence of some or all of the following criteria will generally confirm that a loss has been incurred: the loan is significantly delinquent and the borrower has not evidenced the ability or intent to bring the loan current; the Company has no recourse to the borrower, or if it does, the borrower has insufficient assets to pay the debt; the estimated fair value of the loan collateral is significantly below the current loan balance, and there is little or no near-term prospect for improvement.

A provision of loan losses is charged against income and added to the allowance for loan losses based on regular assessment of the loan portfolio. The allowance for loan losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications, and actual loss experience within the loan portfolio. Although management has allocated the allowance for loan losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

The ultimate recovery of all loans is susceptible to future market factors beyond the Company’s control. These factors may result in losses or recoveries differing significantly from those provided for in the financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company’s allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

Reserve for Unfunded Loan Commitments – The reserve for unfunded loan commitments is maintained at a level believed by management to be sufficient to absorb estimated probable losses related to these unfunded credit facilities. The determination of the adequacy of the reserve is based on periodic evaluations of the unfunded credit facilities including an assessment of the probability of commitment usage, credit risk factors for loans outstanding to these same customers, and the terms and expiration dates of the unfunded credit facilities. The reserve for unfunded loan commitments is included in other liabilities on the balance sheet, with changes to the balance charged against noninterest expense.

Premises and Equipment, Net – Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The estimated useful lives used to compute depreciation include building and building improvements from 25 to 50 years and furniture, fixtures, and equipment from 3 to 10 years. Leasehold and tenant improvements are amortized using the straight-line method over the lesser of useful life or the life of the related lease. Depreciation and amortization expense for these assets totaled $1.1 million and $914,000 for the years ended December 31, 2014 and 2013, respectively. Gains or losses on dispositions are reflected in results of operations.

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Management reviews buildings, improvements and equipment for impairment on an annual basis or whenever events or changes in the circumstances indicate that the undiscounted cash flows for the property are less than its carrying value. If identified, an impairment loss is recognized through a charge to earnings based on the fair value of the property.

Other Real Estate Owned – Other real estate owned ("OREO") consists of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at fair value less selling costs. Costs relating to development and improvement of the properties or assets are capitalized while costs relating to holding the properties or assets are expensed. Valuations are periodically performed by management, and a charge to earnings is recorded if the recorded value of a property exceeds its estimated net realizable value.

Transfers of Financial Assets – Transfers of an entire financial asset, a group of entire financial assets, or participating interest in an entire financial asset are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Servicing Rights – Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage, commercial and consumer loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage, commercial, or consumer servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Servicing assets are evaluated quarterly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranches. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income. Capitalized servicing rights are stated separately on the consolidated balance sheets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. The servicing asset was $3.1 million and $2.1 million at December 31, 2014 and 2013, respectively.

Income Taxes – The Company files a consolidated federal income tax return. Deferred federal income taxes result from temporary differences between the tax basis of assets and liabilities, and their reported amounts in the financial statements. These will result in differences between income for tax purposes and income for financial reporting purposes in future years. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Valuation allowances are established to reduce the net recorded amount of deferred tax assets if it is determined to be more likely than not, that all or some portion of the potential deferred tax asset will not be realized.

As of December 31, 2014, the Company had net deferred tax liabilities of $809,000. As of December 31, 2013, the Company had net deferred tax assets of $816,000 and determined that no valuation allowance was required.

The Financial Accounting Standards Board ("FASB") issued guidance related to accounting for uncertainty in income taxes. The guidance prescribes a recognition threshold and measurement attribute for the financial statement recognition

FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

and measurement of a tax position taken or expected to be taken in a tax return. It is the Company’s policy to record any penalties or interest arising from federal or state taxes as a component of income tax expense.

Earnings Per Share – Basic earnings per share ("EPS") are computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

For purposes of computing basic and dilutive EPS, ESOP shares that have been committed to be released are outstanding and ESOP shares that have not been committed to be released shall not be considered outstanding.

Comprehensive Income (Loss) – Comprehensive income (loss) is comprised of net income and other comprehensive income (loss). Other comprehensive income (loss) includes items recorded directly to equity, such as unrealized gains and losses on securities available-for-sale.

Financial Instruments – In the ordinary course of business, the Company has entered into agreements for off-balance-sheet financial instruments consisting of commitments to extend credit and stand-by letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Restricted Assets – Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the FRB, based on a percentage of deposits. The amounts of such balances for the years ended December 31, 2014 and 2013 were $1.9 million and $1.6 million, respectively, included in interest-bearing deposits at other financial institutions on the balance sheet. The Bank pledged two securities held at the FHLB with a fair value of $1.3 million to secure Washington State public deposits of $1.7 million at December 31, 2014.

Marketing and Advertising Costs – The Company records marketing and advertising costs as expenses as they are incurred. Total marketing and advertising expense was $520,000 and $474,000 for the years ended December 31, 2014 and 2013, respectively.

Employee Stock Ownership Plan ("ESOP") – Compensation expense recognized for the Company's ESOP equals the fair value of shares that have been allocated or committed to be released for allocation to participants. Any difference between the fair value of the shares at the time and the ESOP's original acquisition cost is charged or credited to stockholders' equity (additional paid-in capital). The cost of ESOP shares that have not yet been allocated or committed to be released is deducted from stockholders' equity.

Stock-Based Compensation – Compensation cost is recognized for stock options and restricted stock awards, based on the fair value of these awards at the grant date. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the grant date is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

RECENT ACCOUNTING PRONOUNCEMENTS

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014 - 01, Accounting for Investments in Qualified Affordable Housing Projects. ASU 2014 - 01 permits an entity to make an accounting policy election to account for its investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2014, and should be applied prospectively. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In January 2014, the FASB issued ASU No. 2014 - 04, Receivables - Trouble Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. These amendments are intended to clarify when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate recognized. These amendments clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either: (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additional disclosures are required. Effective for fiscal years, and interim reporting periods within those annual periods beginning after December 15, 2014. The adoption of this ASU is not expected to have a material impact on the Company’s consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014 - 09, Revenue from Contracts with Customers, which creates Topic 606 and supersedes Topic 605, Revenue Recognition. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the ASU requires companies to use more judgment and make more estimates than under current accounting guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The standard is effective for public entities for interim and annual periods beginning after December 15, 2016; early adoption is not permitted. For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company is currently evaluating the provisions of ASU No. 2014-09 to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014 - 11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures, which changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. It also requires additional disclosures about repurchase agreements and other similar transactions. The ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The ASU also requires new and expanded disclosures. This ASU is effective for the first interim or annual period beginning after December 15, 2014. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014 - 12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. The ASU requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing accounting guidance in Topic 718, Compensation - Stock Compensation, as it relates to awards with performance conditions that affect vesting to account for such awards. The performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 1 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. The amendments in this ASU can be applied prospectively or retrospectively and are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015 with early adoption permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014 - 14, Receivables -Troubled Debt Restructuring by Creditors. Under certain government-sponsored loan guarantee programs, such as those offered by the Federal Housing Administration ("FHA") and the Department of Veterans Affairs ("VA"), qualifying creditors can extend mortgage loans to borrowers with a guarantee that entitles the creditor to recover all or a portion of the unpaid principal balance from the government if the borrower defaults. The objective of this ASU is to reduce diversity in practice by addressing the classification of foreclosed mortgage loans that are fully or partially guaranteed under government programs. Currently, some creditors reclassify those loans to real estate as with other foreclosed loans that do not have guarantees; others reclassify the loans to other receivables. The amendments affect creditors that hold government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2014 with early adoption permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014 - 15, Presentation of Financial Statements —Going Concern (Subtopic 205-40). The ASU provides U.S. GAAP guidance on management’s responsibility in evaluating whether there is substantial doubt about a company’s ability to continue as a going concern and about related footnote disclosures. For each reporting period, management will be required to evaluate whether there are conditions or events that raise substantial doubt about a company’s ability to continue as a going concern within one year from the date the financial statements are issued. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In January 2015, the FASB issued ASU No. 2015-1, Income Statement —Extraordinary and Unusual Items (Subtopic 225-20). The objective of this ASU is to simplify the income statement presentation requirements in Subtopic 225-20 by eliminating the concept of extraordinary items. Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Eliminating the extraordinary classification simplifies income statement presentation by altogether removing the concept of extraordinary items from consideration. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015 with early adoption permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

NOTE 2 – SECURITIES AVAILABLE-FOR-SALE

The carrying amount of securities available-for-sale and their approximate fair values at December 31, 2014 and 2013 were as follows:

	December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Values
Securities available-for-sale				
Federal agency securities	$5,998	$3	$(156)	$5,845
Municipal bonds	15,886	326	(51)	16,161
Corporate securities	4,495	—	(58)	4,437
Mortgage-backed securities	20,169	132	(57)	20,244
Small business administration securities	2,019	38	—	2,057
Total securities available-for-sale	$48,567	$499	$(322)	$48,744

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Values
Securities available-for-sale				
Federal agency securities	$12,297	$21	$(651)	$11,667
Municipal bonds	13,347	111	(278)	13,180
Corporate securities	4,005	2	(69)	3,938
Mortgage-backed securities	27,952	66	(564)	27,454
Total securities available-for-sale	$57,601	$200	$(1,562)	$56,239

Investment securities that were in an unrealized loss position as of December 31, 2014 and 2013 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. In the opinion of management, these securities are considered only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

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NOTE 2 – SECURITIES AVAILABLE-FOR-SALE (Continued)

	December 31, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
Federal agency securities	$—	$—	$4,840	$(156)	$4,840	$(156)
Municipal bonds	950	(2)	2,266	(49)	3,216	(51)
Corporate securities	2,977	(18)	1,460	(40)	4,437	(58)
Mortgage-backed securities	3,776	(2)	3,648	(55)	7,424	(57)
Total securities available-for-sale	$7,703	$(22)	$12,214	$(300)	$19,917	$(322)

	December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
Federal agency securities	$4,772	$(244)	$3,591	$(407)	$8,363	$(651)
Municipal bonds	5,915	(206)	1,210	(72)	7,125	(278)
Corporate securities	2,443	(59)	490	(10)	2,933	(69)
Mortgage-backed securities	23,696	(564)	—	—	23,696	(564)
Total securities available-for-sale	$36,826	$(1,073)	$5,291	$(489)	$42,117	$(1,562)

There were eight investments with unrealized losses of less than one year as of December 31, 2014, and 13 investments with unrealized losses of more than one year. There were 31 investments with unrealized losses of less than one year as of December 31, 2013, and seven investments with unrealized losses of more than one year. The unrealized losses associated with these investments are believed to be caused by changing market conditions that are considered to be temporary and the Company has the intent and ability to hold these securities until recovery, and is not likely to be required to sell these securities. No other-than-temporary impairments were recorded for the years ended December 31, 2014 and 2013.

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NOTE 2 – SECURITIES AVAILABLE-FOR-SALE (Continued)

The contractual maturities of securities available-for-sale at December 31, 2014 and 2013 were as follows:

	December 31, 2014		December 31, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$1,503	$1,505	$2,270	$2,282
Due after one year to five years	5,847	5,900	5,323	5,340
Due after five years to ten years	17,191	17,101	20,713	19,905
Due after ten years	24,026	24,238	29,295	28,712
Total	$48,567	$48,744	$57,601	$56,239

The proceeds and resulting gains and losses, computed using specific identification, from sales of investment securities were as follows for the years ended:

	December 31, 2014		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	$20,330	$78	$(119)

	December 31, 2013		
	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	$8,786	$264	$—

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NOTE 3 – LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio was as follows at December 31:

	2014	2013
REAL ESTATE LOANS		
Commercial	$42,970	$32,970
Construction and development	57,813	41,633
Home equity	15,737	15,172
One-to-four-family	46,801	20,809
Multi-family	16,201	4,682
Total real estate loans	179,522	115,266
CONSUMER LOANS		
Indirect home improvement	99,304	91,167
Solar	18,162	16,838
Marine	16,713	11,203
Automobile	674	1,230
Recreational	441	553
Home improvement	329	463
Other	1,184	1,252
Total consumer loans	136,807	122,706
COMMERCIAL BUSINESS LOANS	77,881	49,244
Total loans	394,210	287,216
Allowance for loan losses	(6,090)	(5,092)
Deferred costs, fees, and discounts, net	(946)	(1,043)
Total loans receivable, net	$387,174	$281,081

The Company defined its loan portfolio into three segments that reflect the structure of the lending function, the Company’s strategic plan and the manner in which management monitors performance and credit quality. The three loan portfolio segments are: (a) Real Estate Loans, (b) Consumer Loans and (c) Commercial Business Loans. Each of these segments is disaggregated into classes based on the risk characteristics of the borrower and/or the collateral type securing the loan. The following is a summary of each of the Company’s loan portfolio segments and classes:

Real Estate Loans

Commercial Lending. Loans originated by the Company primarily secured by income producing properties, including retail centers, warehouses and office buildings located in our market areas.

Construction and Development Lending. Loans originated by the Company for the construction of and secured by commercial real estate and one-to-four-family residences and tracts of land for development.

Home Equity Lending. Loans originated by the Company secured by second mortgages on one-to-four-family residences, primarily in our market area.

One-to-Four-Family Real Estate Lending. Loans originated by the Company secured by first mortgages on one-to-four-family residences, primarily in our market area.

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Multi-family Lending. Apartment lending (more than four units) to current banking customers and community reinvestment loans for low to moderate income individuals in the Company's footprint.

Consumer Lending

Indirect Home Improvement. Fixture secured loans are originated by the Company for home improvement and are secured by the personal property installed in, on or at the borrower’s real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower’s residence. These indirect home improvement loans include replacement windows, siding, roofing, and other home fixture installations.

Solar. Fixture secured loans are originated by the Company for home improvement and are secured by the personal property installed in, on or at the borrower’s real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower’s residence.

Marine, Automobile and Recreational. Loans originated by the Company secured by boats, automobiles and RVs to borrowers in our Puget Sound market area.

Other Consumer Loans/Home Improvement. Loans originated by the Company, including direct home improvement loans, loans on deposits and other consumer loans.

Commercial Business Loans

Commercial Business Lending. Commercial business loans originated by the Company to local small and mid-sized businesses in our Puget Sound market area are secured by accounts receivable, inventory, property, plant and equipment, or real estate. Commercial business loans are made on the basis of the borrower’s ability to make repayment from the cash flow of the borrower’s business.

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables detail activities in the allowance for loan losses for the periods shown by loan categories:

	December 31, 2014				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,963	$1,512	$800	$817	$5,092
Provision for loan loss	(62)	619	457	786	1,800
Charge-offs	(213)	(1,408)	(75)	—	(1,696)
Recoveries	184	708	2	—	894
Net charge-offs	(29)	(700)	(73)	—	(802)
Ending balance	$1,872	$1,431	$1,184	$1,603	$6,090
Year-end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$6	$—	$6
Loans collectively evaluated for impairment	1,872	1,431	1,178	1,603	6,084
Ending balance	$1,872	$1,431	$1,184	$1,603	$6,090
LOANS RECEIVABLES					
Loans individually evaluated for impairment	$818	$—	$38	$—	$856
Loans collectively evaluated for impairment	178,704	136,807	77,843	—	393,354
Ending balance	$179,522	$136,807	$77,881	$—	$394,210

	December 31, 2013				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,690	$2,158	$815	$35	$4,698
Provision for loan loss	991	365	32	782	2,170
Charge-offs	(809)	(1,757)	(63)	—	(2,629)
Recoveries	91	746	16	—	853
Net charge-offs	(718)	(1,011)	(47)	—	(1,776)
Ending balance	$1,963	$1,512	$800	$817	$5,092
Year-end amount allocated to:					
Loans individually evaluated for impairment	$85	$—	$6	$—	$91
Loans collectively evaluated for impairment	1,878	1,512	794	817	5,001
Ending balance	$1,963	$1,512	$800	$817	$5,092
LOANS RECEIVABLES					
Loans individually evaluated for impairment	$1,649	$—	$54	$—	$1,703
Loans collectively evaluated for impairment	113,617	122,706	49,190	—	285,513
Ending balance	$115,266	$122,706	$49,244	$—	$287,216

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Information pertaining to aging analysis of past due loans at December 31, 2014 and 2013 are summarized as follows:

	December 31, 2014						
	Loans Past Due and Still Accruing						
	30-59 Days	60-89 Days	90 Days or More Past Due	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	$—	$ —	$42,970	$42,970
Construction and development	—	—	—	—	—	57,813	57,813
Home equity	159	196	—	355	61	15,321	15,737
One-to-four-family	—	—	—	—	73	46,728	46,801
Multi-family	—	—	—	—	—	16,201	16,201
Total real estate loans	159	196	—	355	134	179,033	179,522
CONSUMER							
Indirect home improvement	501	277	—	778	250	98,276	99,304
Solar	—	—	—	—	29	18,133	18,162
Marine	81	—	—	81	19	16,613	16,713
Automobile	13	—	—	13	—	661	674
Recreational	—	—	—	—	—	441	441
Home improvement	—	6	—	6	—	323	329
Other	15	14	—	29	1	1,154	1,184
Total consumer loans	610	297	—	907	299	135,601	136,807
COMMERCIAL BUSINESS LOANS	—	—	—	—	—	77,881	77,881
Total	$769	$493	$—	$1,262	$ 433	$392,515	$394,210

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

	December 31, 2013						
	Loans Past Due and Still Accruing						
	30-59 Days	60-89 Days	90 Days or More Past Due	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	$—	$ 567	$32,403	$32,970
Construction and development	—	—	—	—	—	41,633	41,633
Home equity	63	146	—	209	172	14,791	15,172
One-to-four-family	—	—	—	—	104	20,705	20,809
Multi-family	—	—	—	—	—	4,682	4,682
Total real estate loans	63	146	—	209	843	114,214	115,266
CONSUMER							
Indirect home improvement	533	218	—	751	258	90,158	91,167
Solar	—	—	—	—	—	16,838	16,838
Marine	33	—	—	33	—	11,170	11,203
Automobile	34	13	—	47	—	1,183	1,230
Recreational	39	—	—	39	—	514	553
Home improvement	7	—	—	7	—	456	463
Other	15	6	—	21	—	1,231	1,252
Total consumer loans	661	237	—	898	258	121,550	122,706
COMMERCIAL BUSINESS LOANS	54	—	—	54	—	49,190	49,244
Total	$778	$383	$—	$1,161	$ 1,101	$284,954	$287,216

A loan is considered impaired when it is determined that, based on current information and events, it is probable the Company will be unable to collect payments of principal or interest when due under the terms of the loan. When identifying loans as impaired, management takes into consideration factors which include payment history and status, collateral value, financial condition of the borrower and guarantor, if any, the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered by management on a case-by-case basis, after taking into consideration the circumstances surrounding the loan and the borrower, including payment history and the amounts of any payment shortfall, length and reason for delay and the likelihood of a return to stable performance. Impairment is measured on a loan-by-loan basis for all loans in the portfolio.

The following tables provide additional information at or for the years ended December 31, 2014 and 2013 about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided:

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

	At or For the Year Ended December 31, 2014						
	Unpaid Principal Balance	Write-downs	Recorded Investment	Related Allowance	Adjusted Recorded Investment	Average Recorded Investment	Interest Income Recognized
WITH NO RELATED ALLOWANCE RECORDED							
Commercial	$—	$—	$—	$—	$—	$—	$—
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family	885	(67)	818	—	818	827	39
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Solar	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	—	—	—	—	—	—	—
Subtotal loans	885	(67)	818	—	818	827	39
WITH AN ALLOWANCE RECORDED							
Commercial	—	—	—	—	—	—	—
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Solar	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business	40	(2)	38	(6)	32	45	4

loans						
Subtotal loans	40	(2)	38	(6)	32	45	4
Total	$925	$(69)	$856	$(6)	$850	$872	$43

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

	At or For the Year Ended December 31, 2013						
	Unpaid Principal Balance	Write-downs	Recorded Investment	Related Allowance	Adjusted Recorded Investment	Average Recorded Investment	Interest Income Recognized
WITH NO RELATED ALLOWANCE RECORDED							
Commercial	$—	$—	$—	$—	$—	$—	$—
Construction and development	—	—	—	—	—	—	—
Home equity	39	—	39	—	39	39	—
One-to-four-family	1,212	(169)	1,043	—	1,043	1,041	59
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Solar	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	—	—	—	—	—	—	—
Subtotal loans	1,251	(169)	1,082	—	1,082	1,080	59
WITH AN ALLOWANCE RECORDED							
Commercial	731	(164)	567	(85)	482	622	15
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Solar	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business	56	(2)	54	(6)	48	59	—

loans						
Subtotal loans	787	(166)	621	(91)	530	681	15
Total	$2,038	$(335)	$1,703	$(91)	$1,612	$1,761	$74

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Quality Indicators

As part of the Company’s on-going monitoring of credit quality of the loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grading of loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in the Company’s market.

The Company utilizes a risk grading matrix to assign a risk grade to its real estate and commercial business loans. Loans are graded on a scale of 1 to 10, with loans in risk grades 1 to 6 considered “Pass” and loans in risk grades 7 to 10 are reported as classified loans in the Company's allowance for loan loss analysis.

A description of the 10 risk grades is as follows:

- Grades 1 and 2 – These grades include loans to very high quality borrowers with excellent or desirable business credit.
- Grade 3 – This grade includes loans to borrowers of good business credit with moderate risk.
- Grades 4 and 5 – These grades include “Pass” grade loans to borrowers of average credit quality and risk.
- Grade 6 – This grade includes loans on management’s “Watch” list and is intended to be utilized on a temporary basis for “Pass” grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.
- Grade 7 – This grade is for “Other Assets Especially Mentioned (OAEM)” in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.
- Grade 8 – This grade includes “Substandard” loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.
- Grade 9 – This grade includes “Doubtful” loans in accordance with regulatory guidelines where a loss is highly probable.
- Grade 10 – This grade includes “Loss” loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged-off.

Consumer, Home Equity and One-to-Four-Family Real Estate Loans

Homogeneous loans are risk rated based upon the Uniform Retail Credit Classification Policy and Account Management Policy. Loans classified under these policies at the Company are consumer loans which include indirect home improvement, solar, marine, automobile, recreational, home improvement and other, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded “Pass” and risk graded "4" internally. Our reserve methodology applies a higher reserve factor for consumer loans past due greater than 30 days up to 89 days past due. Loans that are past due more than 90 days are classified “Substandard” risk graded "8" internally. Closed-end loans that are 120 days past due, and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables summarize risk rated loan balances by category at the dates indicated:

	December 31, 2014					
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Total
REAL ESTATE LOANS						
Commercial	$41,559	$545	$—	$866	$—	$42,970
Construction and development	57,813	—	—	—	—	57,813
Home equity	15,676	—	—	61	—	15,737
One-to-four-family	46,200	—	—	601	—	46,801
Multi-family	16,201	—	—	—	—	16,201
Total real estate loans	177,449	545	—	1,528	—	179,522
CONSUMER						
Indirect home improvement	99,054	—	—	250	—	99,304
Solar	18,133	—	—	29	—	18,162
Marine	16,694	—	—	19	—	16,713
Automobile	674	—	—	—	—	674
Recreational	441	—	—	—	—	441
Home improvement	329	—	—	—	—	329
Other	1,183	—	—	1	—	1,184
Total consumer loans	136,508	—	—	299	—	136,807
COMMERCIAL BUSINESS LOANS	68,687	2,020	6,795	379	—	77,881
Total	$382,644	$2,565	$6,795	$2,206	$—	$394,210

	December 31, 2013					
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Total
REAL ESTATE LOANS						
Commercial	$31,500	$903	$—	$567	$—	$32,970
Construction and development	41,633	—	—	—	—	41,633
Home equity	15,000	—	—	172	—	15,172
One-to-four-family	19,766	—	—	1,043	—	20,809
Multi-family	4,682	—	—	—	—	4,682
Total real estate loans	112,581	903	—	1,782	—	115,266
CONSUMER						
Indirect home improvement	90,909	—	—	258	—	91,167
Solar	16,838	—	—	—	—	16,838
Marine	11,203	—	—	—	—	11,203
Automobile	1,230	—	—	—	—	1,230
Recreational	553	—	—	—	—	553
Home improvement	463	—	—	—	—	463
Other	1,252	—	—	—	—	1,252

Total consumer loans	122,448	—	—	258	—	122,706
COMMERCIAL BUSINESS LOANS	38,492	10,698	—	54	—	49,244
Total	$273,521	$11,601	$—	$2,094	$—	$287,216

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Troubled Debt Restructured Loans

Troubled debt restructured ("TDR") loans are loans for which the Company, for economic or legal reasons related to the borrower's financial condition, has granted a significant concession to the borrower that it would otherwise not consider. The loan terms which have been modified or restructured due to a borrower's financial difficulty include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. TDR loans are considered impaired loans and are individually evaluated for impairment. TDR loans can be classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months in which case they are placed on accrual status. The Company had four TDR loans still on accrual and included in impaired loans for both years at December 31, 2014 and 2013. The Company had no commitments to lend additional funds on TDR loans at December 31, 2014.

A summary of TDR loans is as follows:

	2014	2013
Troubled debt restructured loans still on accrual	$783	$815
Troubled debt restructured loans on non-accrual	—	—
Total troubled debt restructured loans	$783	$815

The following tables present TDR loans that occurred during the years ended December 31, 2014 and 2013:

	At or For the Year Ended December 31, 2014			
	Number of Contracts	Recorded Investment	Increase in the Allowance	Charge-offs to the Allowance
Loans	—	$—	$—	$—
Total	—	$—	$—	$—

	At or For the Year Ended December 31, 2013			
	Number of Contracts	Recorded Investment	Increase in the Allowance	Charge-offs to the Allowance
Commercial business loans	1	$35	$—	$35
Total	1	$35	$—	$35

The recorded investments in the tables above are year end balances that are inclusive of all partial pay-downs and charge-offs since the modification date. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by year end are not reported.

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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The TDR loans in the tables above were the result of interest rate modifications and extended payment terms. The Company has not forgiven any principal on the above loans. For the years ended December 31, 2014 and 2013 there were no reported TDR loans that were modified in the previous 12 months that subsequently defaulted in the reporting year.

Related Party Loans
Certain directors and executive officers or their related affiliates are customers of and have had banking transactions with the Company. As of December 31, 2014, there were no new loans or activity, however there was one existing loan to a director with an outstanding balance of $13,000 and an unfunded commitment of $37,000. This loan had an outstanding balance of $5,000 and an unfunded commitment of $45,000 as of December 31, 2013. All loans and commitments included in such transactions were made in compliance with applicable laws on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of collectability or present any other unfavorable features.

NOTE 4 – SERVICING RIGHTS

Loans serviced for others are not included on the consolidated balance sheets. The unpaid principal balances of mortgage, commercial, and consumer loans serviced for others were $345.9 million and $243.0 million at December 31, 2014 and 2013, respectively. The fair market value of the servicing rights' asset at December 31, 2014 and 2013 was $3.5 million and $3.0 million, respectively. Fair value adjustments to servicing rights were mainly due to market based assumptions associated with loan prepayment speeds and changes in interest rates. A significant change in prepayments of the loans in the servicing portfolio could result in significant changes in the valuation adjustments, thus creating potential volatility in the carrying amount of servicing rights.

The following summarizes servicing rights activity for the years ended December 31, 2014 and 2013:

	2014	2013
Beginning balance	$2,093	$1,064
Additions	1,514	1,360
Servicing rights amortized	(564)	(440)
Recovery of loss on servicing rights	18	109
Ending balance	$3,061	$2,093

Fair value adjustments to mortgage, commercial and consumer servicing rights were mainly due to market based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. Valuation assumptions used in determining the fair value of servicing rights at the dates indicated are as follows:

	At December 31,	
	2014	2013
Key assumptions		
Weighted average discount rate	8.5%	8.5%
Weighted average life in years	6.1	8.3

Conditional prepayment rate	13.2	%	7.9	%

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NOTE 4 – SERVICING RIGHTS (Continued)

The Company recorded $722,000 and $517,000 of contractually specified servicing fees, late fees, and other ancillary fees resulting from serving of mortgage, commercial and consumer loans for the years ended December 31, 2014 and 2013, respectively, which is reported in noninterest income.

NOTE 5 – PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2014 and 2013 were as follows:

	2014	2013
Land	$1,767	$1,767
Buildings	7,787	7,787
Furniture, fixtures, and equipment	6,400	5,508
Leasehold improvements	1,551	1,509
Building improvements	3,917	3,829
Projects in process	42	200
	21,464	20,600
Less accumulated depreciation and amortization	(7,880)	(6,782)
Total	$13,584	$13,818

The Company leases premises and equipment under operating leases. Rental expense of leased premises was $590,000 and $470,000 for December 31, 2014 and 2013, respectively, which is included in occupancy expense.

Minimum net rental commitments under non-cancelable leases, having an original or remaining term of more than one year for future years, were as follows:

Year Ending December 31,	
2015	$555
2016	471
2017	446
2018	369
2019	325
Thereafter	649
Total	$2,815

Certain leases contain renewal options from five to ten years and escalation clauses based on increases in property taxes and other costs.

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NOTE 6 – OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO at and for the years ended December 31:

	2014	2013
Beginning balance	$2,075	$2,127
Additions	445	735
Fair value write-downs	(40)	(518)
Disposition of assets	(2,480)	(269)
Ending balance	$—	$2,075

At December 31, 2014, there were no OREO properties. For the years ended December 31, 2014 and 2013, the Company recorded a net loss of $2,000 and $0, respectively, on disposals of OREO. Holding costs associated with OREO were $9,000 and $132,000, for the years ended December 31, 2014 and 2013, respectively.

NOTE 7 – DEPOSITS

Deposits are summarized as follows as of December 31:

	2014	2013
Noninterest-bearing checking	$53,743	$44,309
Interest-bearing checking	29,585	26,725
Savings	21,560	15,345
Money market	152,611	119,162
Certificates of deposits less than $100,000(1)	52,323	46,237
Certificates of deposits $100,000 to $250,000	74,008	52,264
Certificates of deposits $250,000 and over(2)	33,623	31,360
Escrow accounts related to mortgages serviced	2,991	1,474
Total	$420,444	$336,876

(1) Includes $19.1 million and $16.9 million of brokered deposits as of December 31, 2014 and December 31, 2013, respectively.
(2) Time deposits that meet or exceed the FDIC insurance limit.

Scheduled maturities of time deposits for future years ending were as follows:

Year Ending December 31,	
2015	$53,733
2016	59,336
2017	37,062
2018	5,514
2019	4,309
Thereafter	—
Total	$159,954

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NOTE 7 – DEPOSITS (continued)

The Bank pledged two securities held at the FHLB of Seattle with a fair value of $1.3 million to secure Washington State public deposits of $1.7 million, with a collateral requirement of $117,000 by the Washington Public Deposit Protection Commission at December 31, 2014.

FRB regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances at December 31, 2014 and December 31, 2013 were $1.9 million and $1.6 million, respectively, and were in compliance with FRB regulations.

Interest expense by deposit category for the years ended December 31, 2014 and 2013 was as follows:

	2014	2013
Interest-bearing checking	$28	$34
Savings and money market	609	535
Certificates of deposit	1,797	1,409
Total	$2,434	$1,978

The Company had related-party deposits of approximately $456,000 and $428,000 at December 31, 2014 and 2013, respectively, which includes deposits held for directors and executive officers.

NOTE 8 – BORROWINGS

The Bank is a member of the FHLB, which entitles it to certain benefits including a variety of borrowing options consisting of a secured credit line that allows both fixed and variable rate advances. The FHLB bor