Section 1: 10-Q (10-Q)

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

FORM 10-Q

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

For the quarterly period ended September 30, 2019

or

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

For the transition period from ____________ to ____________

Commission File Number: 001-33652

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

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

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, $0.01 par value per share	FFNW	The Nasdaq Stock Market, LLC

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 every Interactive Data File required to be submitted 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 such files).

YES __X__ NO __

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

Large accelerated filer _____ Accelerated filer __X__ Non-accelerated filer _____

Smaller reporting company __X__ Emerging growth company _____

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

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

YES __ NO _X__

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: as of November 6, 2019, 10,289,153 shares of the issuer's common stock, $0.01 par value per share, were outstanding.

FIRST FINANCIAL NORTHWEST, INC.
FORM 10-Q

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

Part 1. Financial Information

Item 1. Financial Statements

Assets	September 30, 2019 (Unaudited)	December 31, 2018
Cash on hand and in banks	$ 7,615	$ 8,122
Interest-earning deposits	6,103	8,888
Investments available-for-sale, at fair value	138,224	142,170
Loans receivable, net of allowance of $13,161 and $13,347	1,083,850	1,022,904
Federal Home Loan Bank ("FHLB") stock, at cost	6,341	7,310
Accrued interest receivable	4,407	4,068
Deferred tax assets, net	1,202	1,844
Other real estate owned ("OREO")	454	483
Premises and equipment, net	22,346	21,331
Bank owned life insurance ("BOLI"), net	31,681	29,841
Prepaid expenses and other assets	4,242	3,458
Goodwill	889	889
Core deposit intangible	1,005	1,116
Total assets	$ 1,308,359	$ 1,252,424
Liabilities and Stockholders' Equity		
Deposits:		
Noninterest-bearing deposits	$ 49,398	$ 46,108
Interest-bearing deposits	967,430	892,924
Total deposits	1,016,828	939,032
FHLB advances	121,000	146,500
Advance payments from borrowers for taxes and insurance	5,043	2,933
Accrued interest payable	382	478
Other liabilities	10,004	9,743
Total liabilities	1,153,257	1,098,686
Commitments and contingencies		
Stockholders' Equity		
Preferred stock, $0.01 par value; authorized 10,000,000 shares; no shares issued or outstanding	—	—
Common stock, $0.01 par value; authorized 90,000,000 shares; issued and outstanding 10,296,053 shares at September 30, 2019, and 10,710,656 shares at December 31, 2018	103	107
Additional paid-in capital	87,835	93,773
Retained earnings	71,592	66,343
Accumulated other comprehensive loss, net of tax	(1,042)	(2,253)
Unearned Employee Stock Ownership Plan ("ESOP") shares	(3,386)	(4,232)
Total stockholders' equity	155,102	153,738
Total liabilities and stockholders' equity	$ 1,308,359	$ 1,252,424

See accompanying selected notes to consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	**2018**	**2019**	**2018**
Interest income				
Loans, including fees	$ 13,897	$ 12,631	$ 40,784	$ 38,103
Investments available-for-sale	1,066	1,063	3,334	3,002
Interest-earning deposits	158	59	246	141
Dividends on FHLB stock	97	135	290	343
Total interest income	15,218	13,888	44,654	41,589
Interest expense				
Deposits	5,037	2,912	13,189	7,623
FHLB advances	529	917	2,255	2,794
Total interest expense	5,566	3,829	15,444	10,417
Net interest income	9,652	10,059	29,210	31,172
Provision (recapture of provision) for loan losses	100	200	(300)	(4,200)
Net interest income after provision (recapture of provision) for loan losses	9,552	9,859	29,510	35,372
Noninterest income				
Net gain (loss) on sale of investments	88	1	80	(20)
BOLI income	235	245	693	718
Wealth management revenue	245	145	702	400
Deposit related fees	179	167	555	503
Loan related fees	290	273	562	533
Other	2	10	26	16
Total noninterest income	1,039	841	2,618	2,150
Noninterest expense				
Salaries and employee benefits	4,813	4,732	14,547	14,325
Occupancy and equipment	924	814	2,688	2,412
Professional fees	440	353	1,262	1,123
Data processing	478	356	1,393	1,031
OREO related expenses, net	1	1	33	4
Regulatory assessments	13	126	286	391
Insurance and bond premiums	95	95	288	355
Marketing	118	85	280	269
Other general and administrative	573	639	1,670	1,805
Total noninterest expense	7,455	7,201	22,447	21,715
Income before federal income tax provision	3,136	3,499	9,681	15,807
Federal income tax provision	631	707	1,927	3,071
Net income	$ 2,505	$ 2,792	$ 7,754	$ 12,736
Basic earnings per common share	$ 0.25	$ 0.27	$ 0.77	$ 1.24
Diluted earnings per common share	$ 0.25	$ 0.27	$ 0.77	$ 1.22
Basic weighted average number of common shares outstanding	9,901,586	10,356,994	9,989,970	10,280,287
Diluted weighted average number of common shares outstanding	9,991,011	10,468,802	10,091,631	10,405,315

See accompanying selected notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	**2018**	**2019**	**2018**
Net income	$ 2,505	$ 2,792	$ 7,754	$ 12,736
Other comprehensive income (loss), before tax:				
Unrealized holding gains (losses) on investments available-for-sale	662	(600)	3,062	(3,002)
Tax (provision) benefit	(139)	126	(643)	630
Reclassification adjustment for net (gains) losses realized in income	(88)	(1)	(80)	20
Tax benefit (provision)	18	—	17	(4)
(Losses) gain on cash flow hedge	(237)	88	(1,449)	928
Tax benefit (provision)	50	(18)	304	(194)
Other comprehensive income (loss), net of tax	266	(405)	1,211	(1,622)
Total comprehensive income	$ 2,771	$ 2,387	$ 8,965	$ 11,114

See accompanying selected notes to consolidated financial statements.

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

	Three Months Ended September 30, 2018						
	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at June 30, 2018	10,916,556	$ 109	$ 96,344	$ 63,042	$ (2,145)	$ (4,796)	$ 152,554
Net income	—	—	—	2,792	—	—	2,792
Other comprehensive loss, net of tax	—	—	—	—	(405)	—	(405)
Issuance of common stock - restricted stock awards, net	—	—	(41)	—	—	—	(41)
Compensation related to stock options and restricted stock awards	—	—	130	—	—	—	130
Allocation of 28,213 ESOP shares	—	—	231	—	—	282	513
Canceled common stock - restricted stock awards	(2,000)	—	—	—	—	—	—
Cash dividend declared and paid ($0.08 per share)	—	—	—	(830)	—	—	(830)
Balances at September 30, 2018	10,914,556	$ 109	$ 96,664	$ 65,004	$ (2,550)	$ (4,514)	$ 154,713

	Nine Months Ended September 30, 2018						
	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2017	10,748,437	$ 107	$ 94,173	$ 54,642	$ (928)	$ (5,360)	$ 142,634
Net income	—	—	—	12,736	—	—	12,736
Other comprehensive loss, net of tax	—	—	—	—	(1,622)	—	(1,622)
Exercise of stock options	137,940	1	1,364	—	—	—	1,365
Issuance of common stock - restricted stock awards, net	30,179	1	(41)	—	—	—	(40)
Compensation related to stock options and restricted stock awards	—	—	539	—	—	—	539
Allocation of 84,640 ESOP shares	—	—	629	—	—	846	1,475
Canceled common stock - restricted stock awards	(2,000)	—	—	—	—	—	—
Cash dividend declared and paid ($0.23 per share)	—	—	—	(2,374)	—	—	(2,374)
Balances at September 30, 2018	10,914,556	$ 109	$ 96,664	$ 65,004	$ (2,550)	$ (4,514)	$ 154,713

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

	Three Months Ended September 30, 2019						
	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at June 30, 2019	10,375,325	$ 104	$ 88,725	$ 69,976	$ (1,309)	$ (3,668)	$ 153,828
Net income	—	—	—	2,505	—	—	2,505
Other comprehensive income, net of tax	—	—	—	—	267	—	267
Issuance of common stock - restricted stock awards, net	8,580	—	—	—	—	—	—
Compensation related to stock options and restricted stock awards	—	—	226	—	—	—	226
Allocation of 28,214 ESOP shares	—	—	120	—	—	282	402
Repurchase and retirement of common stock	(87,852)	(1)	(1,236)	—	—	—	(1,237)
Cash dividend declared and paid ($0.09 per share)	—	—	—	(889)	—	—	(889)
Balances at September 30, 2019	10,296,053	$ 103	$ 87,835	$ 71,592	$ (1,042)	$ (3,386)	$ 155,102

	Nine Months Ended September 30, 2019						
	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2018	10,710,656	$ 107	$ 93,773	$ 66,343	$ (2,253)	$ (4,232)	$ 153,738
Net income	—	—	—	7,754	—	—	7,754
Other comprehensive income, net of tax	—	—	—	—	1,211	—	1,211
Issuance of common stock - restricted stock awards, net	25,278	—	(93)	—	—	—	(93)
Compensation related to stock options and restricted stock awards	—	—	457	—	—	—	457
Allocation of 84,640 ESOP shares	—	—	444	—	—	846	1,290
Repurchase and retirement of common stock	(433,952)	(4)	(6,746)	—	—	—	(6,750)
Canceled common stock - restricted stock awards	(5,929)	—	—	—	—	—	—
Cash dividend declared and paid ($0.26 per share)	—	—	—	(2,592)	—	—	(2,592)
Beginning balance adjustment from adoption of Topic 842	—	—	—	87	—	—	87
Balances at September 30, 2019	10,296,053	$ 103	$ 87,835	$ 71,592	$ (1,042)	$ (3,386)	$ 155,102

See accompanying selected notes to consolidated financial statements.

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

	Nine Months Ended September 30,	
	2019	**2018**
Cash flows from operating activities:		
Net income	$ 7,754	$ 12,736
Adjustments to reconcile net income to net cash provided by operating activities:		
Recapture of provision for loan losses	(300)	(4,200)
OREO market value adjustments	29	—
Net amortization of premiums and discounts on investments	626	812
(Gain) loss on sale of investments available-for-sale	(80)	20
Depreciation of premises and equipment	1,330	1,228
Loss on sale of premises and equipment	5	—
Deferred federal income taxes	320	(449)
Allocation of ESOP shares	1,290	1,475
Stock compensation expense	457	539
BOLI income	(693)	(718)
Changes in operating assets and liabilities:		
(Increase) decrease in prepaid expenses and other assets	(2,122)	2,319
Increase in advance payments from borrowers for taxes and insurance	2,110	2,222
Increase in accrued interest receivable	(339)	(580)
(Decrease) increase in accrued interest payable	(96)	215
Increase in other liabilities	348	337
Net cash provided by operating activities	10,639	15,956
Cash flows from investing activities:		
Proceeds from sales, calls and maturities of investments available-for-sale	5,057	15,186
Principal repayments on investments available-for-sale	4,859	5,385
Purchases of investments available-for-sale	(3,534)	(33,011)
Net increase in loans receivable	(60,646)	(2,695)
Redemption of FHLB stock	969	2,472
Purchase of premises and equipment	(2,350)	(1,891)
Proceeds from BOLI	310	—
Purchase of BOLI	(1,457)	—
Net cash used by investing activities	(56,792)	(14,554)
Cash flows from financing activities:		
Net increase in deposits	$ 77,796	$ 76,777
Advances from the FHLB	196,500	320,500
Repayments of advances from the FHLB	(222,000)	(387,500)
Proceeds from stock options exercises	—	1,365
Net share settlement of stock awards	(93)	(40)
Repurchase and retirement of common stock	(6,750)	—
Dividends paid	(2,592)	(2,374)
Net cash provided by financing activities	42,861	8,728

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2019	**2018**
Net (decrease) increase in cash and cash equivalents	(3,292)	10,130
Cash and cash equivalents at beginning of period	17,010	16,131
Cash and cash equivalents at end of period	$ 13,718	$ 26,261
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest paid	$ 15,540	$ 10,202
Federal income taxes paid	1,860	3,175
Noncash items:		
Change in unrealized loss on investments available-for-sale	$ 2,982	$ (2,982)
Change in gain on cash flow hedge	(1,449)	928
Initial recognition of right-of-use asset	1,853	—
Initial recognition of lease liability	1,853	—

See accompanying selected notes to consolidated financial statements.

Note 1 - Description of Business

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

At September 30, 2019, First Financial Northwest Bank operated in eleven locations in Washington with the headquarters and six branch locations in King County and five branch locations in Snohomish County. The Bank has received regulatory approval to open an additional branch in Kirkland, Washington, located in King County. This branch is scheduled to open in the fourth quarter of 2019. In addition, the Bank has applied for regulatory approval to open a new branch in University Place, Washington, which would expand the Bank’s presence into Pierce County. The Bank’s primary market area consists of King, Snohomish, Pierce and Kitsap counties, Washington.

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

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

Note 2 - Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles (“GAAP”) for complete financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2018, as filed with the SEC (“2018 Form 10-K”). In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the unaudited interim consolidated financial statements in accordance with GAAP have been included. All significant intercompany balances and transactions between the Company and its subsidiaries have been eliminated in consolidation. Operating results for the nine months ended September 30, 2019, are not necessarily indicative of the results that may be expected for the year ending December 31, 2019. In preparing the unaudited consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the allowance for loan and lease losses (“ALLL”), the valuation of other real estate owned (“OREO”) and the underlying collateral of impaired loans, deferred tax assets, the right-of-use asset and lease liability on our operating leases, and the fair value of financial instruments.

The Company’s activities are considered to be a single industry segment for financial reporting purposes. The Company is engaged in the business of attracting deposits from the general public and originating and purchasing loans for its portfolio. Substantially all income is derived from a diverse base of commercial, multifamily, and residential real estate loans, consumer lending activities, and investments.

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

Note 3 - Recently Issued Accounting Pronouncements

Recent Accounting Pronouncements Adopted in 2019

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, *Leases (Topic 842)*. ASU No. 2016-02 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. In July 2018, FASB issued ASU No. 2018-11, *Leases (Topic 842)* to address the comparative reporting requirements when this ASU is adopted. In March 2019, FASB issued ASU 2019-01, *Leases (Topic 842), Codification Improvements*. Under these ASUs, a lessee should recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For a finance lease, interest payments should be recognized separately from amortization of the right-of-use asset in the statement of comprehensive income. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis. The Company adopted this ASU on January 1, 2019 and according to ASU 2018-11, elected to recognize the related cumulative-effect adjustment as an adjustment to the opening balance of retained earnings. Adoption of ASU 2016-02 resulted in the addition of a right-of-use asset and lease related to certain banking offices under noncancelable operating lease agreements. The resulting increase did not to have a material impact on the Company's consolidated financial statements or regulatory capital ratios. For more information see Note 8 - Leases in this report.

In March 2017, FASB issued ASU No. 2017-08, *Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The ASU shortens the amortization period for certain callable debt securities held at a premium. The Company adopted this ASU as of January 1, 2019, with no material impact on the Company's consolidated financial statements.

Recent Accounting Pronouncements

ASU No. 2016-13, *Financial Instruments - Credit Losses (Topic 326)* as amended by ASU 2018-19, ASU 2019-04 and ASU 2019-05, was originally issued in June 2016. This ASU replaces the existing incurred loss impairment methodology that recognizes credit losses when a probable loss has been incurred with new methodology where loss estimates are based upon lifetime expected credit losses. The amendments in this ASU require a financial asset that is measured at amortized cost to be presented at the net amount expected to be collected. The income statement would then reflect the measurement of credit losses for newly recognized financial assets as well as changes to the expected credit losses that have taken place during the reporting period. The measurement of expected credit losses will be based on historical information, current conditions, and reasonable and supportable forecasts that impact the collectability of the reported amount. Available-for-sale securities will bifurcate the fair value mark and establish an allowance for credit losses through the income statement for the credit portion of that mark. The interest portion will continue to be recognized through accumulated other comprehensive income or loss. The change in allowance recognized as a result of adoption will occur through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the ASU is adopted. This ASU is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, assuming the adoption of an ASU implementing the FASB Board decision in October 2019 to extend the adoption date for smaller reporting companies, such as the Company. The Company is evaluating our current expected loss methodology of our loan and investment portfolios to identify the necessary modifications in accordance with this standard and expects a change in the processes and procedures to calculate the ALLL, including changes in assumptions and estimates to consider expected credit losses over the life of the loan versus the current accounting practice that utilizes the incurred loss model. A valuation adjustment to our ALLL or investment portfolio that is identified in this process will be reflected as a one-time adjustment in equity rather than earnings. ASU 2019-05 issued in April 2019 further provides that entities that have certain financial instruments measured at amortized cost that have credit losses, to irrevocably elect the fair value option in Subtopic 825-10, upon adoption of Topic 326. The fair value option applies to available-for-sale debt securities. This ASU is effective upon adoption of ASU 2016-13, and should be applied on a modified-retrospective basis as a cumulative-effect adjustment to the opening balance of retained earnings in the statement of financial condition as of the adoption date. We are in the process of compiling historical and industry data that will be used to calculate expected credit losses on our loan portfolio to ensure we are fully compliant with the ASU at the adoption date and are evaluating the potential impact adoption of this ASU will have on our consolidated financial statements. The Company intends to adopt ASU 2016-13 in the first quarter of 2023, and as a result, our allowance for loan losses may increase. Until our evaluation is complete, however, the magnitude of the increase will not be known.

In August 2018, FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820) - Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement.* The amendments in this ASU remove certain disclosure requirements regarding transfers between Level 1 and Level 2 of the fair value hierarchy and changes in unrealized gains and losses for recurring

Level 3 fair value measurements. In addition, the amendments modified and added certain disclosure requirements for Level 3 fair value measurements. This ASU is effective for fiscal years beginning after December 15, 2019, and early adoption is permitted. Entities are permitted to early adopt any removed or modified disclosures and adopt the additional disclosures at the effective date. Adoption of ASU 2018-13 is not expected to have a material impact on the Company's consolidated financial statements.

In April 2019, FASB issued ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments--Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments.* This ASU provides clarification and guidance on recently issued ASUs regarding recognition and measurement of financial assets, credit losses on financial instruments and accounting for derivatives and hedging activities. This ASU is effective for fiscal years beginning after December 15, 2019 for the portions related to topics 326 an 825. For the portion related to topic 815, this ASU is effective for concurrent adoption with ASU 2016-13. Adoption of ASU 2019-04 is not expected to have a material impact on the Company's consolidated financial statements.

In April 2019, FASB issued ASU 2019-05, *Financial Instruments--Credit Losses (Topic 326), Targeted Transition Relief.* The amendments in this ASU provide entities that have certain financial instruments measured at amortized cost that have credit losses, to irrevocably elect the fair value option in Subtopic 825-10, upon adoption of Topic 326. The fair value option applies to available-for-sale debt securities. This ASU is effective when ASU 2016-13 is adopted, and will be applied on a modified-retrospective basis as a cumulative-effect adjustment to the opening balance of retained earnings in the statement of financial condition as of the adoption date. Adoption of ASU 2019-05 is not expected to have a material impact on the Company's consolidated financial statements.

Note 4 - Investments

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

	September 30, 2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$ 23,182	$ 315	$ (9)	$ 23,488
Freddie Mac	6,231	159	—	6,390
Ginnie Mae	22,642	201	(243)	22,600
Other	11,660	113	(21)	11,752
Municipal bonds	6,376	312	—	6,688
U.S. Government agencies	44,706	43	(756)	43,993
Corporate bonds	23,492	343	(522)	23,313
Total	$ 138,289	$ 1,486	$ (1,551)	$ 138,224

	December 31, 2018			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$ 24,276	$ 24	$ (657)	$ 23,643
Freddie Mac	6,351	10	(74)	6,287
Ginnie Mae	23,311	—	(1,250)	22,061
Other	8,983	17	(21)	8,979
Municipal bonds	10,615	49	(120)	10,544
U.S. Government agencies	48,190	73	(825)	47,438
Corporate bonds	23,490	399	(671)	23,218
Total	$ 145,216	$ 572	$ (3,618)	$ 142,170

The tables below summarize the aggregate fair value and gross unrealized loss by length of time those investment securities have been continuously in an unrealized loss position at the dates indicated:

	September 30, 2019					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
	(In thousands)					
Mortgage-backed investments:						
Fannie Mae	$ 4,822	$ (9)	$ —	$ —	$ 4,822	$ (9)
Freddie Mac	—	—	—	—	—	—
Ginnie Mae	—	—	13,581	(243)	13,581	(243)
Other	—	—	6,000	(21)	6,000	(21)
Municipal bonds	—	—	—	—	—	—
U.S. Government agencies	10,072	(154)	29,034	(602)	39,106	(756)
Corporate bonds	—	—	6,978	(522)	6,978	(522)
Total	$ 14,894	$ (163)	$ 55,593	$ (1,388)	$ 70,487	$ (1,551)

	December 31, 2018					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
	(In thousands)					
Mortgage-backed investments:						
Fannie Mae	$ 5,480	$ (32)	$ 16,721	$ (625)	$ 22,201	$ (657)
Freddie Mac	1,994	(23)	3,185	(51)	5,179	(74)
Ginnie Mae	2,867	(8)	19,194	(1,242)	22,061	(1,250)
Other	6,008	(21)	—	—	6,008	(21)
Municipal bonds	4,161	(46)	934	(74)	5,095	(120)
U.S. Government agencies	5,985	(13)	30,779	(812)	36,764	(825)
Corporate bonds	—	—	6,828	(671)	6,828	(671)
Total	$ 26,495	$ (143)	$ 77,641	$ (3,475)	$ 104,136	$ (3,618)

On a quarterly basis, management makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security on which there is an unrealized loss is impaired on an other-than-temporary basis. The Company considers many factors including the severity and duration of the impairment, recent events specific to the issuer or industry, and for debt securities, external credit ratings and recent downgrades. Securities on which there is an unrealized loss that is deemed to be an other-than-temporary impairment ("OTTI") are written down to fair value. If the Company intends to sell a debt security, or it is likely that the Company will be required to sell the debt security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If the Company does not intend to sell the debt security and it is not likely that it will be required to sell the debt security but does not expect to recover the entire amortized cost basis of the debt security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a debt security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the debt security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ("OCI"). Impairment losses related to all other factors are presented as separate categories within OCI. The Company had 26 securities and 51 securities in an unrealized loss position, respectively, with 17 and 31 of these securities in an unrealized loss position for 12 months or more, at September 30, 2019, and December 31, 2018, respectively. Management does not believe that any individual unrealized loss as of September 30, 2019, or December 31, 2018, represented OTTI. The decline in fair market value of these securities was generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. Management also reviewed the financial condition of the entities issuing municipal or corporate bonds at September 30, 2019, and December 31, 2018, and determined that an OTTI charge was not warranted.

The amortized cost and estimated fair value of investments available-for-sale at September 30, 2019, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments not due at a single maturity date, primarily mortgage-backed investments, are shown separately.

	September 30, 2019	
	Amortized Cost	Fair Value
	(In thousands)	
Due within one year	$ 496	$ 498
Due after one year through five years	6,683	6,790
Due after five years through ten years	18,669	18,442
Due after ten years	48,726	48,264
	74,574	73,994
Mortgage-backed investments	63,715	64,230
Total	$ 138,289	$ 138,224

Under Washington state law, in order to participate in the public funds program the Company is required to pledge eligible securities as collateral in an amount equal to 50% of the public deposits held less the FDIC insured amount. Investment securities with market values of $15.7 million and $15.6 million were pledged as collateral for public deposits at September 30, 2019, and December 31, 2018, respectively, both of which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission.

For the three months ended September 30, 2019, there were sales and maturities on investment securities of $2.0 million, generating a net gain of $88,000. For the nine months ended September 30, 2019, there were calls, sales, and maturities on investment securities of $5.1 million, generating a net gain of $80,000. For the three and nine months ended September 30, 2018, the Bank had calls, sales, and maturities on investment securities of $5.4 million, and $15.2 million, respectively, generating a net gain of $1,000 and a net loss of $20,000, respectively.

Note 5 - Loans Receivable

Loans receivable are disclosed net of loans in process (“LIP”) and are summarized as follows at the dates indicated:

	September 30, 2019	December 31, 2018
	(In thousands)	
One-to-four family residential:		
Permanent owner occupied	$ 205,679	$ 194,141
Permanent non-owner occupied	164,707	147,825
	370,386	341,966
Multifamily	171,152	169,355
Commercial real estate	381,890	373,798
Construction/land:		
One-to-four family residential	47,524	51,747
Multifamily	40,078	40,502
Commercial	15,913	9,976
Land	6,400	6,629
	109,915	108,854
Business	37,507	30,486
Consumer	26,451	12,970
Total loans	1,097,301	1,037,429
Less:		
Deferred loan fees, net	290	1,178
Allowance for loan and lease losses ("ALLL")	13,161	13,347
Loans receivable, net	$ 1,083,850	$ 1,022,904

At September 30, 2019, loans totaling $498.8 million were pledged to secure borrowings from the FHLB of Des Moines compared to $471.4 million at December 31, 2018. In addition, loans totaling $90.6 million and $91.2 million were pledged to the Federal Reserve Bank of San Francisco to secure a line of credit at September 30, 2019 and December 31, 2018, respectively.

Credit Quality Indicators. The Company assigns a risk rating to all credit exposures based on a risk rating system designed to define the basic characteristics and identified risk elements of each credit extension. The Company utilizes a nine-point risk rating system. A description of the general characteristics of the risk grades is as follows:

- Grades 1 through 5: These grades are considered to be “pass” credits. These include assets where there is limited credit risk, such as cash secured loans with funds on deposit with the Bank. Pass credits also include credits that are on the Company’s watch list, where the borrower exhibits potential weaknesses, which may, if not checked or corrected, negatively affect the borrower’s financial capacity and threaten their ability to fulfill debt obligations in the future.

- Grade 6: These credits, classified as “special mention”, possess weaknesses that deserve management’s close attention. Special mention assets do not expose the Company to sufficient risk to warrant adverse classification in the substandard, doubtful or loss categories. If left uncorrected, these potential weaknesses may result in deterioration in the Company’s credit position at a future date.

- Grade 7: These credits, classified as “substandard”, present a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. These credits have well defined weaknesses which jeopardize the orderly liquidation of the debt and are inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged.

- Grade 8: These credits are classified as “doubtful” and possess well defined weaknesses which make the full collection or liquidation of the loan highly questionable and improbable. This classification is used where significant risk exposures are perceived but the exact amount of the loss cannot yet be determined due to pending events.

- Grade 9: Assets classified as “loss” are considered uncollectible and cannot be justified as a viable asset for the Company. There is little or no prospect of near term recovery and no realistic strengthening action of significance is pending.

As of September 30, 2019, and December 31, 2018, the Company had no loans rated as doubtful or loss. The following tables represent a summary of loans at September 30, 2019, and December 31, 2018 by type and risk category:

	September 30, 2019						
	One-to-Four Family Residential	**Multifamily**	**Commercial Real Estate**	**Construction/ Land**	**Business**	**Consumer**	**Total**
	(In thousands)						
Risk Rating:							
Pass	$ 369,213	$ 169,041	$ 381,361	$ 98,306	$ 37,507	$ 26,412	$ 1,081,840
Special mention	540	2,111	529	11,609	—	—	14,789
Substandard	633	—	—	—	—	39	672
Total loans	$ 370,386	$ 171,152	$ 381,890	$ 109,915	$ 37,507	$ 26,451	$ 1,097,301

	December 31, 2018						
	One-to-Four Family Residential	**Multifamily**	**Commercial Real Estate**	**Construction/ Land**	**Business**	**Consumer**	**Total**
	(In thousands)						
Risk Rating:							
Pass	$ 339,310	$ 169,355	$ 372,690	$ 108,854	$ 30,486	$ 12,926	$ 1,033,621
Special mention	1,737	—	782	—	—	—	2,519
Substandard	919	—	326	—	—	44	1,289
Total loans	$ 341,966	$ 169,355	$ 373,798	$ 108,854	$ 30,486	$ 12,970	$ 1,037,429

ALLL. When the Company classifies problem assets as either substandard or doubtful, pursuant to Federal regulations, or identifies a loan where it is uncertain if the Bank will be able to collect all amounts due according to the contractual terms of the loan, it may establish a specific reserve in an amount deemed prudent to address the risk specifically. 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 the particular problem assets. When an insured institution classifies problem assets as a loss, pursuant to Federal regulations, it is required to charge-off such assets in the period in which they are deemed uncollectible. The determination as to the classification of the Company’s assets and the amount of valuation allowances is subject to review by bank regulators, who can require the establishment of additional allowances for loan losses.

Loan grades are used by the Company to identify and track potential problem loans which do not rise to the levels described for substandard, doubtful, or loss. The grades for watch and special mention are assigned to loans which have been criticized based upon known characteristics such as periodic payment delinquency, failure to comply with contractual terms of the loan or stale financial information from the borrower and/or guarantors. Loans identified as criticized (watch and special mention) or classified (substandard, doubtful or loss) are subject to problem loan reporting every three months.

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

	At or For the Three Months Ended September 30, 2019						
	One-to-Four Family Residential	**Multifamily**	**Commercial Real Estate**	**Construction/ Land**	**Business**	**Consumer**	**Total**
	(In thousands)						
ALLL:							
Beginning balance	$ 3,085	$ 1,643	$ 4,607	$ 2,271	$ 1,120	$ 331	$ 13,057
Recoveries	3	—	—	—	—	1	4
(Recapture) provision	(56)	91	(122)	(73)	37	223	100
Ending balance	$ 3,032	$ 1,734	$ 4,485	$ 2,198	$ 1,157	$ 555	$ 13,161

	At or For the Nine Months Ended September 30, 2019						
	One-to-Four Family Residential	**Multifamily**	**Commercial Real Estate**	**Construction/ Land**	**Business**	**Consumer**	**Total**
	(In thousands)						
ALLL:							
Beginning balance	$ 3,387	$ 1,680	$ 4,777	$ 2,331	$ 936	$ 236	$ 13,347
Recoveries	31	45	—	—	—	38	114
(Recapture) provision	(386)	9	(292)	(133)	221	281	(300)
Ending balance	$ 3,032	$ 1,734	$ 4,485	$ 2,198	$ 1,157	$ 555	$ 13,161
ALLL by category:							
General reserve	$ 3,001	$ 1,734	$ 4,485	$ 2,198	$ 1,157	$ 555	$ 13,130
Specific reserve	31	—	—	—	—	—	31
Loans:							
Total loans	$ 370,386	$ 171,152	$ 381,890	$ 109,915	$ 37,507	$ 26,451	$ 1,097,301
Loans collectively evaluated for impairment [1]	365,813	171,152	379,764	98,306	37,507	26,412	1,078,954
Loans individually evaluated for impairment [2]	4,573	—	2,126	11,609	—	39	18,347

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[1] Loans collectively evaluated for general reserves.
[2] Loans individually evaluated for specific reserves.

	At or For the Three Months Ended September 30, 2018						
	One-to-Four Family Residential	**Multifamily**	**Commercial Real Estate**	**Construction/ Land**	**Business**	**Consumer**	**Total**
	(In thousands)						
ALLL:							
Beginning balance	$ 3,265	$ 1,928	$ 4,494	$ 2,121	$ 674	$ 272	$ 12,754
Recoveries	2	—	—	160	—	—	162
Provision (recapture)	265	(189)	(16)	(84)	236	(12)	200
Ending balance	$ 3,532	$ 1,739	$ 4,478	$ 2,197	$ 910	$ 260	$ 13,116

	At or For the Nine Months Ended September 30, 2018						
	One-to-Four Family Residential	**Multifamily**	**Commercial Real Estate**	**Construction/ Land**	**Business**	**Consumer**	**Total**
	(In thousands)						
ALLL:							
Beginning balance	$ 2,837	$ 1,820	$ 4,418	$ 2,816	$ 694	$ 297	$ 12,882
Recoveries	4,248	—	14	172	—	—	4,434
(Recapture) provision	(3,553)	(81)	46	(791)	216	(37)	(4,200)
Ending balance	$ 3,532	$ 1,739	$ 4,478	$ 2,197	$ 910	$ 260	$ 13,116
ALLL by category:							
General reserve	$ 3,446	$ 1,739	$ 4,471	$ 2,197	$ 910	$ 260	$ 13,023
Specific reserve	86	—	7	—	—	—	93
Loans:							
Total loans	$ 327,924	$ 176,521	$ 360,261	$ 103,009	$ 29,655	$ 12,419	$ 1,009,789
Loans collectively evaluated for impairment [1]	318,353	175,405	357,335	103,009	29,655	12,330	996,087
Loans individually evaluated for impairment [2]	9,571	1,116	2,926	—	—	89	13,702

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[1] Loans collectively evaluated for general reserves.
[2] Loans individually evaluated for specific reserves.

Past Due Loans. Loans are considered past due if a scheduled principal or interest payment is due and unpaid for 30 days or more. At September 30, 2019, past due loans were 0.03% of total loans receivable, net of LIP. In comparison, past due loans were 0.08% of total loans receivable, net of LIP at December 31, 2018. The following tables represent a summary of the aging of loans by type at the dates indicated:

	Loans Past Due as of September 30, 2019					
	30-59 Days	60-89 Days	90 Days and Greater	Total Past Due	Current	Total [1]
	(In thousands)					
Real estate:						
One-to-four family residential:						
Owner occupied	$ —	$ —	$ —	$ —	$ 205,679	$ 205,679
Non-owner occupied	—	—	—	—	164,707	164,707
Multifamily	—	—	—	—	171,152	171,152
Commercial real estate	—	—	—	—	381,890	381,890
Construction/land	—	—	—	—	109,915	109,915
Total real estate	—	—	—	—	1,033,343	1,033,343
Business	—	—	—	—	37,507	37,507
Consumer	321	—	—	321	26,130	26,451
Total loans	$ 321	$ —	$ —	$ 321	$ 1,096,980	$ 1,097,301

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[1] There were no loans 90 days and greater past due and still accruing interest at September 30, 2019.

	Loans Past Due as of December 31, 2018					
	30-59 Days	60-89 Days	90 Days and Greater	Total Past Due	Current	Total [1]
	(In thousands)					
Real estate:						
One-to-four family residential:						
Owner occupied	$ 223	$ —	$ 272	$ 495	$ 193,646	$ 194,141
Non-owner occupied	—	—	—	—	147,825	147,825
Multifamily	—	—	—	—	169,355	169,355
Commercial real estate	—	—	326	326	373,472	373,798
Construction/land	—	—	—	—	108,854	108,854
Total real estate	223	—	598	821	993,152	993,973
Business	—	—	—	—	30,486	30,486
Consumer	—	—	—	—	12,970	12,970
Total loans	$ 223	$ —	$ 598	$ 821	$ 1,036,608	$ 1,037,429

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[1] There were no loans 90 days and greater past due and still accruing interest at December 31, 2018.

Nonperforming Loans. When a loan becomes 90 days past due, the Bank generally places the loan on nonaccrual status. Loans may be placed on nonaccrual status prior to being 90 days past due if there is an identified problem that indicates the borrower is unable to meet their scheduled payment obligations. The following table is a summary of nonaccrual loans by loan type at the dates indicated:

	September 30, 2019	December 31, 2018
	(In thousands)	
One-to-four family residential	$ 98	$ 382
Commercial real estate	—	326
Consumer	39	44
Total nonaccrual loans	$ 137	$ 752

During the three and nine months ended September 30, 2019, interest income that would have been recognized had these nonaccrual loans been performing in accordance with their original terms was $2,000 and $11,000, respectively. For the three and nine months ended September 30, 2018, foregone interest on nonaccrual loans was $4,000 and $10,000, respectively.

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

	September 30, 2019						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land	Business	Consumer	Total
	(In thousands)						
Performing (1)	$ 370,288	$ 171,152	$ 381,890	$ 109,915	$ 37,507	$ 26,412	$ 1,097,164
Nonperforming (2)	98	—	—	—	—	39	137
Total loans	$ 370,386	$ 171,152	$ 381,890	$ 109,915	$ 37,507	$ 26,451	$ 1,097,301

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(1) There were $205.6 million of owner-occupied one-to-four family residential loans and $164.7 million of non-owner occupied one-to-four family residential loans classified as performing.
(2) The $98,000 one-to-four family residential loan classified as nonperforming is owner-occupied.

	December 31, 2018						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land	Business	Consumer	Total
	(In thousands)						
Performing (1)	$ 341,584	$ 169,355	$ 373,472	$ 108,854	$ 30,486	$ 12,926	$ 1,036,677
Nonperforming (2)	382	—	326	—	—	44	752
Total loans	$ 341,966	$ 169,355	$ 373,798	$ 108,854	$ 30,486	$ 12,970	$ 1,037,429

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(1) There were $193.8 million of owner-occupied one-to-four family residential loans and $147.8 million of non-owner occupied one-to-four family residential loans classified as performing.
(2) The $382,000 of one-to-four family residential loans classified as nonperforming are all owner-occupied.

Impaired Loans. A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the original loan document or the borrower failing to comply with contractual terms of the loan. At September 30, 2019, an impaired construction loan with an outstanding balance of $11.6 million had $4.1 million of funds committed to be advanced; however, advancement of the $4.1 million of additional funds was frozen at that date. There were no funds committed to be advanced in connection with impaired loans at December 31, 2018.

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

	September 30, 2019		
	Recorded Investment [1]	Unpaid Principal Balance [2]	Related Allowance
		(In thousands)	
Loans with no related allowance:			
One-to-four family residential:			
Owner occupied	$ 828	$ 1,012	$ —
Non-owner occupied	1,580	1,580	—
Commercial real estate	2,127	2,127	—
Construction/land	11,608	15,650	—
Consumer	39	69	—
Total	16,182	20,438	—
Loans with an allowance:			
One-to-four family residential:			
Owner occupied	507	554	15
Non-owner occupied	1,658	1,658	16
Total	2,165	2,212	31
Total impaired loans:			
One-to-four family residential:			
Owner occupied	1,335	1,566	15
Non-owner occupied	3,238	3,238	16
Commercial real estate	2,127	2,127	—
Construction/land	11,608	15,650	—
Consumer	39	69	—
Total	$ 18,347	$ 22,650	$ 31

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

	December 31, 2018		
	Recorded Investment [(1)]	Unpaid Principal Balance [(2)]	Related Allowance
		(In thousands)	
Loans with no related allowance:			
One-to-four family residential:			
Owner occupied	$ 1,308	$ 1,477	$ —
Non-owner occupied	2,375	2,375	—
Commercial real estate	2,499	2,499	—
Consumer	87	141	—
Total	6,269	6,492	—
Loans with an allowance:			
One-to-four family residential:			
Owner occupied	513	560	22
Non-owner occupied	3,126	3,148	37
Commercial real estate	241	241	3
Total	3,880	3,949	62
Total impaired loans:			
One-to-four family residential:			
Owner occupied	1,821	2,037	22
Non-owner occupied	5,501	5,523	37
Commercial real estate	2,740	2,740	3
Consumer	87	141	—
Total	$ 10,149	$ 10,441	$ 62

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

The following table presents the average recorded investment in loans individually evaluated for impairment and the interest income recognized for the three and nine months ended September 30, 2019 and 2018:

	Three Months Ended September 30, 2019		Nine Months Ended September 30, 2019	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$ 834	$ 15	$ 956	$ 44
Non-owner occupied	1,633	24	1,920	74
Commercial real estate	2,134	38	2,231	114
Construction/land	11,596	202	5,798	570
Consumer	41	1	53	3
Total	16,238	280	10,958	805
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	508	9	510	26
Non-owner occupied	1,661	24	2,203	69
Commercial real estate	—	—	60	—
Total	2,169	33	2,773	95
Total impaired loans:				
One-to-four family residential:				
Owner occupied	1,342	24	1,466	70
Non-owner occupied	3,294	48	4,123	143
Commercial real estate	2,134	38	2,291	114
Construction/land	11,596	202	5,798	570
Consumer	41	1	53	3
Total	$ 18,407	$ 313	$ 13,731	$ 900

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$ 1,049	$ 18	$ 1,182	$ 55
Non-owner occupied	5,112	83	6,385	298
Multifamily	1,119	19	1,125	55
Commercial real estate	2,402	42	1,732	133
Consumer	90	2	92	6
Total	9,772	164	10,516	547
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	517	9	519	26
Non-owner occupied	3,160	40	3,232	122
Commercial real estate	373	5	1,247	22
Total	4,050	54	4,998	170
Total impaired loans:				
One-to-four family residential:				
Owner occupied	1,566	27	1,701	81
Non-owner occupied	8,272	123	9,617	420
Multifamily	1,119	19	1,125	55
Commercial real estate	2,775	47	2,979	155
Consumer	90	2	92	6
Total	$ 13,822	$ 218	$ 15,514	$ 717

Troubled Debt Restructurings. Certain loan modifications are accounted for as troubled debt restructured loans ("TDRs"). At September 30, 2019, the TDR portfolio totaled $6.6 million. At December 31, 2018, the TDR portfolio totaled $9.4 million. At both dates, all TDRs were performing according to their modified repayment terms.

At September 30, 2019, the Company had no commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment as part of the calculation of the ALLL. No loans accounted for as TDRs were charged-off to the ALLL for the three and nine months ended September 30, 2019 and 2018.

The following table presents TDR modifications for the periods indicated and their recorded investment prior to and after the modification:

	Three Months Ended September 30, 2019			Nine Months Ended September 30, 2019		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(Dollars in thousands)					
One-to-four family residential						
Principal and interest with interest rate concession and advancement of maturity date	1	$ 536	$ 536	7	$ 1,360	$ 1,360
Advancement of maturity date	—	—	—	3	694	694
Commercial						
Advancement of maturity date	1	855	855	1	855	855
Total	2	$ 1,391	$ 1,391	11	$ 2,909	$ 2,909

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
	(Dollars in thousands)					
One-to-four family residential						
Advancement of maturity date	1	$ 563	$ 563	1	$ 563	$ 563
Commercial						
Advancement of maturity date	—	—	—	1	1,124	1,124
Total	1	$ 563	$ 563	2	$ 1,687	$ 1,687

TDRs that default after they have been modified are typically evaluated individually on a collateral basis. Any additional impairment is charged to the ALLL. For the three and nine months ended September 30, 2019, and September 30, 2018, no loans that had been modified in the previous 12 months defaulted.

Note 6 - Other Real Estate Owned

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
	(In thousands)			
Balance at beginning of period	$ 454	$ 483	$ 483	$ 483
Market value adjustments	—	—	(29)	—
Balance at end of period	$ 454	$ 483	$ 454	$ 483

For the three and nine months ended September 30, 2019, there were no OREO properties sold. Based on current appraisals, there were no market value adjustments taken on the properties in OREO for the three months ended September 30, 2019. There were $29,000 in market value adjustments taken on the properties in OREO for the nine months ended September 30, 2019. For the three and nine months ended September 30, 2018, there were no sales or market value adjustments on OREO properties. OREO at September 30, 2019, consisted of $454,000 in commercial real estate properties. At September 30, 2019, there were no loans for which formal foreclosure proceedings were in process.

Note 7 - Fair Value

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

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

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

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

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

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

The Company used the following methods to measure fair value on a recurring or nonrecurring basis:

- *Financial instruments with book value equal to fair value:* The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value. These instruments include cash on hand and in banks, interest-earning deposits with banks, FHLB stock, accrued interest receivable and accrued interest payable. FHLB stock is not publicly-traded, however it may be redeemed on a dollar-for-dollar basis, for any amount the Bank is not required to hold, subject to the FHLB's discretion. The fair value is therefore equal to the book value.

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

- *Loans receivable:* The fair value of loans receivable are based on the exit price notion, and are calculated from inputs reflective of current market pricing for similar instruments, to include current origination spreads, liquidity premiums, and credit adjustments. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

- *Derivatives:* The fair value of derivatives is based on dealer quotes, pricing models, discounted cash flow methodologies or similar techniques for which the determination of fair value may require significant management judgment or estimation.

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

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

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

The tables below present the balances of assets measured at fair value on a recurring basis (there were no transfers between Level 1, Level 2 and Level 3 recurring measurements) at September 30, 2019 and December 31, 2018:

	Fair Value Measurements at September 30, 2019			
	Fair Value Measurements	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
	(In thousands)			
Investments available-for-sale:				
Mortgage-backed investments:				
Fannie Mae	$ 23,488	$ —	$ 23,488	$ —
Freddie Mac	6,390	—	6,390	—
Ginnie Mae	22,600	—	22,600	—
Other	11,752	—	11,752	—
Municipal bonds	6,688	—	6,688	—
U.S. Government agencies	43,993	—	43,993	—
Corporate bonds	23,313	—	23,313	—
Total available-for-sale investments	138,224	—	138,224	—
Derivative fair value asset	213	—	213	—
Total	$ 138,437	$ —	$ 138,437	$ —

	Fair Value Measurements at December 31, 2018			
	Fair Value Measurements	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
	(In thousands)			
Investments available-for-sale:				
Mortgage-backed investments:				
Fannie Mae	$ 23,643	$ —	$ 23,643	$ —
Freddie Mac	6,287	—	6,287	—
Ginnie Mae	22,061	—	22,061	—
Other	8,979	—	8,979	—
Municipal bonds	10,544	—	10,544	—
U.S. Government agencies	47,438	—	47,438	—
Corporate bonds	23,218	—	23,218	—
Total available-for-sale investments	142,170	—	142,170	—
Derivative fair value asset	1,662	—	1,662	—
Total	$ 143,832	$ —	$ 143,832	$ —

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

The tables below present the balances of assets measured at fair value on a nonrecurring basis at September 30, 2019, and December 31, 2018:

	Fair Value Measurements at September 30, 2019			
	Fair Value Measurements	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
	(In thousands)			
Impaired loans (included in loans receivable, net) [1]	$ 18,316	$ —	$ —	$ 18,316
OREO	454	—	—	454
Total	$ 18,770	$ —	$ —	$ 18,770

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[1] Total fair value of impaired loans is net of $31,000 of specific reserves on performing TDRs.

	Fair Value Measurements at December 31, 2018			
	Fair Value Measurements	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
	(In thousands)			
Impaired loans (included in loans receivable, net) [1]	$ 10,087	$ —	$ —	$ 10,087
OREO	483	—	—	483
Total	$ 10,570	$ —	$ —	$ 10,570

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[1] Total fair value of impaired loans is net of $62,000 of specific reserves on performing TDRs.

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

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

The following tables present quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at September 30, 2019 and December 31, 2018:

	September 30, 2019			
	Fair Value	**Valuation Technique**	**Unobservable Input(s)**	**Range (Weighted Average)**
	(Dollars in thousands)			
Impaired Loans	$ 18,316	Market approach	Appraised value discounted by market or borrower conditions	0.0% - 1.13% (0.13%)
OREO	$ 454	Market approach	Appraised value less selling costs	0.0% (0.00%)

	December 31, 2018				
	Fair Value		Valuation Technique	Unobservable Input(s)	Range (Weighted Average)
	(Dollars in thousands)				
Impaired Loans	$	10,087	Market approach	Appraised value discounted by market or borrower conditions	0.0% (0.0%)
OREO	$	483	Market approach	Appraised value less selling costs	0.0% (0.0%)

The carrying amounts and estimated fair values of financial instruments were as follows at the dates indicated:

	September 30, 2019				
		Estimated	Fair Value Measurements Using:		
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash on hand and in banks	$ 7,615	$ 7,615	$ 7,615	$ —	$ —
Interest-earning deposits with banks	6,103	6,103	6,103	—	—
Investments available-for-sale	138,224	138,224	—	138,224	—
Loans receivable, net	1,083,850	1,070,591	—	—	1,070,591
FHLB stock	6,341	6,341	—	6,341	—
Accrued interest receivable	4,407	4,407	—	4,407	—
Derivative fair value asset	213	213	—	213	—
Financial Liabilities:					
Deposits	456,964	456,964	456,964	—	—
Certificates of deposit, retail	421,274	427,118	—	427,118	—
Certificates of deposit, brokered	138,590	138,794	—	138,794	—
Advances from the FHLB	121,000	121,387	—	121,387	—
Accrued interest payable	382	382	—	382	—

	December 31, 2018				
		Estimated	Fair Value Measurements Using:		
	Carrying Value	Fair Value	Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash on hand and in banks	$ 8,122	$ 8,122	$ 8,122	$ —	$ —
Interest-earning deposits with banks	8,888	8,888	8,888	—	—
Investments available-for-sale	142,170	142,170	—	142,170	—
Loans receivable, net	1,022,904	1,012,114	—	—	1,012,114
FHLB stock	7,310	7,310	—	7,310	—
Accrued interest receivable	4,068	4,068	—	4,068	—
Derivative fair value asset	1,662	1,662	—	1,662	—
Financial Liabilities:					
Deposits	450,033	450,033	450,033	—	—
Certificates of deposit, retail	391,174	390,101	—	390,101	—
Certificates of deposit, brokered	97,825	97,466	—	97,466	—
Advances from the FHLB	146,500	146,357	—	146,357	—
Accrued interest payable	478	478	—	478	—

Note 8 - Leases

The Company adopted ASU 2016-02 and ASU 2018-11 using the modified retrospective approach with an effective date of January 1, 2019, and recognized on the consolidated balance sheets a right-of-use asset (“ROU”) included in prepaid expenses and other assets and lease liabilities included in other liabilities. As such, prior year financial statements were not restated under the new standard. At September 30, 2019, the Company had ten operating leases for retail branch locations. The remaining lease terms range from 11 months to 5.75 years, with most leases carrying optional extensions of 3-5 years. The Company will include optional lease term extensions in the ROU assets and lease liabilities when management believes it is reasonably certain that the term extension will be exercised, and will be determined based on indicators that the Company would have an economic incentive to extend the lease. The Company has elected to not apply ASU 2016-02 to short term leases, which are those that have a term of one year or less. To calculate the present value of lease payments not yet paid, the Company uses the incremental borrowing rate, which is equal to the FHLB advance rate for the remaining term of the lease that was in place at January 1, 2019, or for leases added after that date, at the time of lease inception.

The minimum monthly lease payments are generally based on square footage of the leased premises, with escalating minimum rent over the lease term. At September 30, 2019, the Company was committed to paying $52,000 per month in minimum monthly lease payments. The minimum monthly lease payment over the initial lease term, including any free rent period, was used to calculate the ROU and lease liability. The Company’s current leases do not include any non-lease components.

Total lease expense included in the Company’s Consolidated Income Statement for the three and nine months ended September 30, 2019, was $170,000 and $514,000, respectively. Lease expense includes the amortized lease expense under ASU 2016-02 combined with variable lease expenses for maintenance or other expenses as defined in the individual lease agreements. The right-of-use asset and lease liability both had a balance of $1.5 million on the Company’s consolidated balance sheet at September 30, 2019, and are amortizing over a weighted-average remaining term of 3.9 years. The weighted-average discount rate used to calculate the present value of future minimum lease payments was 2.97% at September 30, 2019.

The following table provides a reconciliation between the undiscounted minimum lease payments at September 30, 2019 and the discounted lease liability at that date:

	September 30, 2019
	(in thousands)
Due through one year	$ 533
Due after one year through two years	361
Due after two years through three years	292
Due after three years through four years	217
Due after four years through five years	152
Due after five years	53
Total minimum lease payments	1,608
Less: present value discount	(95)
Lease liability	$ 1,513

The Company has secured a lease for a new retail branch in Kirkland, Washington, which is expected to commence in the fourth quarter of 2019. The initial lease term is for 65 months and includes options to extend the lease. The minimum rent will be determined at commencement and will increase annually thereafter. This lease was not included in the calculation of discounted lease payments at September 30, 2019.

Note 9 - Derivatives

The Company uses derivative financial instruments, in particular, interest rate swaps, which qualify as cash flow hedges, to manage the risk of changes in future cash flows due to interest rate fluctuations. In October 2016, the Company entered into a five-year, $50.0 million notional pay fixed, receive floating interest rate swap agreement for which the Company will pay 1.34% monthly and in exchange will receive variable rate amounts from the interest rate swap counter party based on three-month LIBOR. In September 2019, the Company entered into a five-year, $15.0 million notional pay fixed, receive floating interest rate swap agreement for which the Company will pay 1.44% monthly and in exchange will receive variable rate amounts from the interest rate swap counter party based on one-month LIBOR. The Company pays or receives the net interest amount monthly or quarterly, based on the respective hedge agreement, and includes this amount as part of its interest expense on the Consolidated Income Statement.

Quarterly, the effectiveness evaluation is based upon the fluctuation of the interest the Company pays to the FHLB for the hedge instruments as compared to the one-month or three-month LIBOR interest received from the counterparty. At September 30, 2019, the fair value of the cash flow hedges of $213,000 was reported with other assets. The tax effected amount of $168,000 was included in Accumulated Other Comprehensive Income. There were no amounts recorded in the Consolidated Income Statements for the quarters ended September 30, 2019 or 2018, related to ineffectiveness.

Fair value for these derivative instruments, which generally changes as a result of changes in the level of market interest rates, is estimated based on dealer quotes and secondary market sources.

The following table presents the fair value of these derivative instruments as of September 30, 2019 and December 31, 2018:

	Balance Sheet Location	Fair Value at September 30, 2019	Fair Value at December 31, 2018
		(In thousands)	
Interest rate swaps on FHLB debt designated as a cash flow hedge	Other Assets	$ 213	$ 1,662
Total derivatives		$ 213	$ 1,662

The following table presents the net unrealized gains and losses from these derivative instruments included on the Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2019, and September 30, 2018:

	Balance Sheet Location	Amount Recognized in OCI for the three months ended September 30, 2019	Amount Recognized in OCI for the three months ended September 30, 2018	Amount Recognized in OCI for the nine months ended September 30, 2019	Amount Recognized in OCI for the nine months ended September 30, 2018
			(In thousands)		
Interest rate swaps on FHLB debt designated as a cash flow hedge	Equity	$ (187)	$ 70	$ (1,145)	$ 734

Note 10 - Stock-Based Compensation

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

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

As a result of the approval of the 2016 Plan, the First Financial Northwest, Inc. 2008 Equity Incentive Plan ("2008 Plan") was frozen and no additional awards will be made. At September 30, 2019, there were no unvested shares of restricted stock awards under the 2008 Plan. At this date, there were 16,000 stock options granted under the 2008 Plan that are expected to vest and be available for exercise, and an additional 299,000 stock options from the 2008 Plan were available for exercise at September 30, 2019, subject to the 2008 Plan provisions. At September 30, 2019, there were 1,190,114 total shares available for grant under the 2016 Plan, including 320,057 shares available to be granted as restricted stock.

For the three months ended September 30, 2019 and 2018, total compensation expense for both the 2008 and 2016 Plans was $226,000 and $130,000, respectively, and the related income tax benefit was $48,000 and $27,000, respectively.

For the nine months ended September 30, 2019 and 2018, total compensation expense for both the 2008 and 2016 Plans was $457,000 and $539,000, respectively, and the related income tax benefit was $96,000 and $113,000, respectively.

Stock Options

Under the 2008 Plan, stock option awards were granted with an exercise price equal to the market price of First Financial Northwest's common stock at the grant date. These option awards have a vesting period of 5 years, with 20% vesting on the anniversary date of each grant date, and a contractual life of 10 years. Any unexercised stock options expire ten years after the grant date, or sooner in the event of the award recipient's death, disability or termination of service with the Company and the Bank.

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

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

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

A summary of the Company's stock option plan awards and activity for the three and nine months ended September 30, 2019, follows:

	For the Three Months Ended September 30, 2019				
	Shares	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term in Years**	**Aggregate Intrinsic Value**	**Weighted-Average Grant Date Fair Value**
Outstanding at July 1, 2019	365,000	$ 11.09		1,199,800	$ 3.88
Outstanding at September 30, 2019	365,000	11.09	4.93	1,398,250	3.88
Vested and expected to vest assuming a 3% forfeiture rate over the vesting term	363,020	11.07	4.91	1,397,415	3.87
Exercisable at September 30, 2019	299,000	10.20	4.14	1,370,410	3.64

	For the Nine Months Ended September 30, 2019				
	Shares	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Term in Years**	**Aggregate Intrinsic Value**	**Weighted-Average Grant Date Fair Value**
Outstanding at January 1, 2019	315,000	$ 10.34		$ 1,615,600	$ 3.69
Granted	50,000	15.80			5.03
Outstanding at September 30, 2019	365,000	11.09	4.93	1,398,250	3.88
Vested and expected to vest assuming a 3% forfeiture rate over the vesting term	363,020	11.07	4.91	1,397,415	3.87
Exercisable at September 30, 2019	299,000	10.20	4.14	1,370,410	3.64

As of September 30, 2019, there was $252,000 of total unrecognized compensation cost related to nonvested stock options granted under the 2008 and 2016 Plans. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.79 years. There were 50,000 stock options granted under the 2016 Plan during the nine months ended September 30, 2019.

Restricted Stock Awards

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

A summary of changes in nonvested restricted stock awards for the three and nine months ended September 30, 2019, follows:

	For the Three Months Ended September 30, 2019	
	Shares	**Weighted-Average Grant Date Fair Value**
Nonvested at July 1, 2019	16,698	$ 16.53
Granted	8,580	14.62
Vested	(8,580)	14.62
Nonvested at September 30, 2019	16,698	16.53
Expected to vest assuming a 3% forfeiture rate over the vesting term	16,197	16.53

	For the Nine Months Ended September 30, 2019	
	Shares	**Weighted-Average Grant Date Fair Value**
Nonvested at January 1, 2019	20,987	$ 15.90
Granted	25,278	15.88
Vested	(29,567)	15.53
Nonvested at September 30, 2019	16,698	16.53
Expected to vest assuming a 3% forfeiture rate over the vesting term	16,197	16.53

As of September 30, 2019, there was $113,000 of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of five months, three days.

Note 11 - Earnings Per Share

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

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	**2018**	**2019**	**2018**
	(Dollars in thousands, except share data)			
Net income	$ 2,505	$ 2,792	$ 7,754	$ 12,736
Less: Earnings allocated to participating securities	(4)	(5)	(12)	(24)
Earnings allocated to common shareholders	$ 2,501	$ 2,787	$ 7,742	$ 12,712
Basic weighted average common shares outstanding	9,901,586	10,356,994	9,989,970	10,280,287
Dilutive stock options	83,423	101,350	95,985	117,645
Dilutive restricted stock grants	6,002	10,458	5,676	7,383
Diluted weighted average common shares outstanding	9,991,011	10,468,802	10,091,631	10,405,315
Basic earnings per share	$ 0.25	$ 0.27	$ 0.77	$ 1.24
Diluted earnings per share	$ 0.25	$ 0.27	$ 0.77	$ 1.22

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three and nine months ended September 30, 2019, there were 50,000 options to purchase shares of common stock that were omitted from the computation of diluted earnings per share because their effect would be anti-dilutive. For the three and nine months ended September 30, 2018, there no options to purchase shares of common stock that were omitted from the computation of diluted earnings per share because their effect would be anti-dilutive.

Note 12 - Branch Acquisition

On August 25, 2017, First Financial Northwest Bank completed the acquisition of four branches from Opus Bank, a California state-chartered commercial bank (the “Branch Acquisition”). The Branch Acquisition included four retail branches located in Woodinville, Clearview, Lake Stevens, and Smokey Point, Washington. The Bank acquired $74.7 million of retail deposits, prior to the fair value adjustment, one owned bank branch, three leased branches, and certain fixed assets at these branches. The purchase price of the Branch Acquisition paid by the Bank included a deposit premium of 3.125% of the average daily balance of acquired deposits for 20 days prior to the closing date, or $2.5 million; 80% of the fair market value of the owned branch, or $488,000; the net book value of fixed assets, or $56,000; and $14,000 for other pro rations and adjustments as of the closing date. Opus Bank paid the Bank $71.6 million in cash for the difference between these amounts and the total deposits assumed.

The Branch Acquisition was accounted for under the acquisition method of accounting, and accordingly, the assets received and liabilities assumed were recorded at their fair market value as of August 25, 2017. The application of the acquisition method of accounting resulted in recognition of a core deposit intangible asset (“CDI”) of $1.3 million and goodwill of $889,000. The acquired CDI has been determined to have a useful life of approximately ten years and is amortized on an accelerated basis. Goodwill is not amortized but will be evaluated for impairment on an annual basis, or more often if circumstances dictate, to determine if the carrying value remains appropriate. The balance of the CDI and goodwill at September 30, 2019 was $1.0 million and $889,000, respectively.

Note 13 - Revenue Recognition

In accordance with Topic 606, revenues are recognized when goods or services are transferred to the customer in exchange for the consideration the Company expects to be entitled to receive. To determine the appropriate recognition of revenue for transactions within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with the customer; (ii) identify the separate performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the separate performance obligations in the contract; and (v) recognize revenue when the entity satisfies a performance obligation. A contract may not exist if there are doubts as to collectability of the amounts the Company is entitled to in exchange for the goods or services transferred. If a contract is determined to be within the scope of Topic 606, the Company recognizes revenue as it satisfies a performance obligation. The largest portion of the Company's revenue is from net interest income which is not within the scope of Topic 606.

Disaggregation of Revenue

The following table includes the Company's noninterest income disaggregated by type of service for the three and nine months ended September 30, 2019 and 2018:

	Three Months Ended		Nine Months Ended	
	September 30, 2019	September 30, 2018	September 30, 2019	September 30, 2018
	(In thousands)			
Gain (loss) on sale of investments [1]	$ 88	$ 1	$ 80	$ (20)
BOLI change in cash surrender value [1]	235	245	693	718
Wealth management revenue	245	145	702	400
Deposit related fees	61	63	218	197
Debit card and ATM fees	118	104	337	306
Loan related fees	99	163	265	353
Loan interest swap fees	191	110	297	180
Other	2	10	26	16
Total noninterest income	$ 1,039	$ 841	$ 2,618	$ 2,150

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[1] Not within scope of Topic 606

For the three and nine months ended September 30, 2019, substantially all of the Company's revenues under the scope of Topic 606 are for performance obligations satisfied at a specified date.

Revenues recognized within scope of Topic 606

Wealth management revenue: Our wealth management revenue consists of commissions received on the investment portfolio managed by Bank personnel but held by a third party. Commissions are earned on brokerage services and advisory services based on contract terms at the onset of a new customer's investment agreement or quarterly for ongoing services. Commissions are paid by the third party to the Bank when the performance obligation has been completed by both entities.

Deposit related fees: Fees are earned on our deposit accounts for various products or services performed for our customers. Fees include business account fees, non-sufficient fund fees, stop payment fees, wire services, safe deposit box, and others. These fees are recognized on a daily or monthly basis, depending on the type of service.

Debit card and ATM fees: Fees are earned when a debit card issued by the Bank is used or when other bank's customers use our ATM services. Revenue is recognized at the time the fees are collected from the customer's account or remitted by the VISA interchange network.

Loan related fees: Noninterest fee income is earned on our loans for servicing or annual fees on certain loan types.

Loan interest swap fees: For loans participating in an interest rate swap agreement, fees are earned at the onset of the agreement and are not contingent on any future performance or term length of the loan itself. The performance obligation is satisfied by entering into the contract and receipt of the fees from the counterparty.

Other: Fees earned on other services, such as merchant services or occasional non-recurring type services, are recognized at the time of the event or the applicable billing cycle.

Contract Balances

At September 30, 2019, the Company had no contract liabilities where the Company had an obligation to transfer goods or services for which the Company had already received consideration. In addition, the Company had no material performance obligations as of this date.

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

Forward-Looking Statements

Certain matters discussed in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about, among other things, expectations of the business environment in which we operate, projections of future performance or financial items, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs, that may be affected by deterioration in the housing and commercial real estate markets, and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve Bank of San Francisco and our bank subsidiary by the Federal Deposit Insurance Corporation ("FDIC"), the Washington State Department of Financial Institutions, Division of Banks ("DFI") or other regulatory authorities, including the possibility that any such regulatory authority may initiate an enforcement action against the Company or the Bank which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements or restrictions on us, any of which could adversely affect our liquidity and earnings; our ability to pay dividends on our common stock; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining the fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; disruptions, security breaches, or other adverse events, failures or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and the implementing regulations; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our filings with the U.S. Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended December 31, 2018 ("2018 Form 10-K"). Any of the forward-looking statements that we make in this Form 10-Q and in the other public reports and statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

Overview

First Financial Northwest Bank ("the Bank") is a wholly-owned subsidiary of First Financial Northwest, Inc. ("the Company") and, as such, comprises substantially all of the activity for the Company. First Financial Northwest Bank was a community-based savings bank until February 4, 2016, when the Bank converted to a Washington chartered commercial bank reflecting the commercial banking services it now provides to its customers. The Bank primarily serves King, Pierce, Snohomish, and Kitsap counties, Washington, through its full-service banking office and headquarters in Renton, Washington, as well as five retail branches in King County, Washington and five retail branches in Snohomish County, Washington. The Bank has received FDIC approval to open a new branch in Kirkland, Washington. This additional King County location is expected to open in the fourth quarter of 2019. In addition, the Bank has applied for regulatory approval to open a new branch in University Place, Washington, which would expand the Bank's presence into Pierce County.

The Bank's business consists predominantly of attracting deposits from the general public, combined with borrowing from the Federal Home Loan Bank of Des Moines ("FHLB") and raising funds in the wholesale market (including brokered deposits), then utilizing these funds to originate one-to-four family residential, multifamily, commercial real estate, construction/land, business, and consumer loans. We anticipate that construction/land lending will continue to be a strong element of our total loan portfolio in future periods. We will continue to take a disciplined approach in our construction/land lending by concentrating our efforts on residential loans to builders known to us, including multifamily loans to developers with proven success in this type of construction. These loans typically mature in six to eighteen months and funding is usually not fully disbursed at origination, therefore the impact to net loans receivable is generally minimal in the short term. We have also geographically expanded our loan portfolio through loan purchases or loan participations of commercial and multifamily real estate loans and consumer loans that are outside of our primary market area. Through our efforts to geographically diversify our loan portfolio with direct loan originations, loan participations, or loan purchases, our portfolio includes loans in 36 other states, including concentrations in California, Utah, Arizona and Oregon of $44.5 million, $16.2 million, $14.6 million and $12.0 million, respectively.

The Bank's strategic initiatives seek to diversify our loan portfolio and broaden growth opportunities with our current risk tolerance levels and asset/liability objectives. The Bank is creating a small business loan ("SBA") department, with the goal of achieving SBA preferred lender status by 2020, which would provide the Bank with delegated loan approval as well as closing and most servicing and liquidation authority, enabling the Bank to make loan decisions more rapidly. In addition, the Bank plans to increase originations of the business loan portfolio, which may include business lines of credit, business term loans, equipment financing, and a focus on industry specific loans, such as green energy financing. In conjunction with the growth of business loans, the Bank seeks to service these customers with their business deposits as well.

The Bank continues to develop its aircraft loan portfolio through both originations and purchases of aircraft loans. The underwriting on these loans is predominantly asset centered, with secondary emphasis placed on the ability of the borrower to repay the loan. We began originating aircraft loans in the fourth quarter of 2016. At September 30, 2019, our business loans included $14.2 million in fixed and adjustable rate aircraft loans, with an average balance of $676,000.

Our primary source of revenue is interest income, which is the income that we earn on our loans and investments. Interest expense is the interest that we pay on our deposits and borrowings. Net interest income is the difference between interest income and interest expense. Changes in levels of interest rates affect interest income and interest expense differently and, thus, impacts our net interest income. First Financial Northwest Bank is generally liability-sensitive, meaning our interest-bearing liabilities reprice at a faster rate than our interest-earning assets.

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

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

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

Critical Accounting Policies

Our significant accounting policies are fundamental to understanding our results of operations and financial condition because they require that we use estimates and assumptions that may affect the value of our assets or liabilities and our financial results. These policies are critical because they require management to make difficult, subjective, and complex judgments about matters that are inherently uncertain and because it is likely that materially different amounts would be reported under different conditions or by using different assumptions. These policies govern the ALLL, the valuation of OREO, and the calculation of deferred taxes, the right-of-use asset and lease liability on our operating leases, fair values, and other-than-temporary impairments on the market value of investments and derivatives. These policies and estimates are described in further detail in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies in the 2018 Form 10-K. There have not been any material changes in the Company's critical accounting policies and estimates as compared to the disclosure contained in the 2018 Form 10-K.

Comparison of Financial Condition at September 30, 2019 and December 31, 2018

Total assets were $1.31 billion at September 30, 2019, an increase of 4.5%, from $1.25 billion at December 31, 2018. The following table details the $55.9 million net change in the composition of our assets at September 30, 2019 from December 31, 2018.

	Balance at September 30, 2019	Change from December 31, 2018	Percent Change
		(Dollars in thousands)	
Cash on hand and in banks	$ 7,615	$ (507)	(6.2)%
Interest-earning deposits with banks	6,103	(2,785)	(31.3)
Investments available-for-sale, at fair value	138,224	(3,946)	(2.8)
Loans receivable, net	1,083,850	60,946	6.0
FHLB stock, at cost	6,341	(969)	(13.3)
Accrued interest receivable	4,407	339	8.3
Deferred tax assets, net	1,202	(642)	(34.8)
OREO	454	(29)	(6.0)
Premises and equipment, net	22,346	1,015	4.8
BOLI, net	31,681	1,840	6.2
Prepaid expenses and other assets	4,242	784	22.7
Goodwill	889	—	—
Core deposit intangible	1,005	(111)	(9.9)
Total assets	$ 1,308,359	$ 55,935	4.5 %

Interest-earning deposits with banks. Our interest-earning deposits with banks, consisting primarily of funds held at the Federal Reserve Bank of San Francisco ("FRB"), decreased by $2.8 million from December 31, 2018, to September 30, 2019. These funds fluctuate based on our funding needs, and decreased during the previous nine months to partially support the growth in loans receivable.

Investments available-for-sale. Our investments available-for-sale portfolio decreased by $3.9 million during the nine months ended September 30, 2019. During this period, we sold $4.7 million of municipal bonds and had a call of $30,000 and maturity of $250,000 in U.S. government agency bonds. At September 30, 2019, corporate bonds issued by financial institutions represented $23.3 million, or 16.9% of our investments available-for-sale and municipal bonds represented $6.7 million, or 4.8% of our investments available-for-sale.

The effective duration of the investments available-for-sale at September 30, 2019, was 2.60% as compared to 3.00% at December 31, 2018. Effective duration measures the anticipated percentage change in the value of an investment security (or portfolio) in the event of a 100 basis point change in market yields. Since the Bank's portfolio includes securities with embedded options (including call options on bonds and prepayment options on mortgage-backed securities), management believes that effective duration is an appropriate metric to use as a tool when analyzing the Bank's investment securities portfolio, as effective duration incorporates assumptions relating to such embedded options, including changes in cash flow assumptions as interest rates change.

Loans receivable. Total loans receivable increased by $59.9 million to $1.1 billion at September 30, 2019, as compared to December 31, 2018. Loan originations of $203.4 million were supplemented with $41.8 million of loan purchases and participations discussed in detail below, to offset loan repayments and to continue growth of our loan portfolio. During the nine months ended September 30, 2019, one-to-four family residential loans increased by $28.4 million, commercial real estate loans increased by $8.1 million, multifamily loans increased by $1.8 million and construction/land loans increased by $1.1 million. In addition, consumer loans increased by $13.5 million and business loans increased by $7.0 million.

Our loan concentrations remained stable at September 30, 2019 as compared to December 31, 2018. At these dates, the Bank's construction loans totaled 82.6% and 81.9% of total capital, respectively, and total non-owner occupied commercial real estate was 444.9% and 451.8% of total capital, respectively. The Bank has set aggregate concentration guidelines that total commercial real estate, including residential, non-residential, and construction loans, should not exceed 550% of total risk-based capital. Our concentration guideline for construction/land loans is to limit these loans to 100% of total risk-based capital. The concentration of construction/land loans is calculated using the funded balance of these loans and consequently can fluctuate based on the timing of construction draws and loan payoffs. Management reviews estimated construction draws and loan payoffs and adjusts loan originations based on these estimates to achieve compliance with our construction guidelines. Our commercial and multifamily real estate and construction/land loan portfolios are subject to ongoing credit reviews performed by both independent loan review staff, as well as an external third-party review firm to assist with identifying potential adverse trends and risks in the portfolio allowing management to initiate timely corrective action, as necessary. Such reviews also assist with ensuring loan risk grades are accurately assigned and thereby properly accounted for in the ALLL. The review places emphasis on large borrowing relationships, stress testing, compliance with loan covenants, as well as other risk factors warranting enhanced review.

The following table presents a breakdown of our multifamily, commercial and construction loan portfolio by collateral type at September 30, 2019 and December 31, 2018. Previously, we reported the gross loan balance in this table, however, as a better representation of the loan receivable at the dates shown, amounts shown below are reported net of LIP. At September 30, 2019, total construction/land loans are net of $88.1 million of LIP. At December 31, 2018, total commercial loans and total construction/land loans are net of $21,000 and $86.4 million, respectively, of LIP.

	September 30, 2019	December 31, 2018
	(In thousands)	
Multifamily residential:		
Other multifamily	$ 157,275	$ 155,279
Micro-unit apartments	13,877	14,076
Total multifamily residential	171,152	169,355
Non-residential		
Retail	142,639	131,222
Office	98,738	100,495
Storage	35,908	32,462
Motel	27,572	28,035
Warehouse	18,200	25,398
Nursing home	16,104	16,315
Mobile home park	23,070	16,003
Other non-residential	19,659	23,868
Total non-residential	381,890	373,798
Construction/land:		
One-to-four family residential	47,524	51,747
Multifamily	40,078	40,502
Commercial	15,913	9,976
Land	6,400	6,629
Total construction/land	109,915	108,854
Total multifamily residential, non-residential and construction/land loans	$ 662,957	$ 652,007

Included in total construction/land loans at September 30, 2019, are $29.5 million of multifamily loans, $15.9 million of commercial real estate loans and $3.2 million of one-to-four family loans that will roll over to permanent loans at the completion of their construction period in accordance with the terms of the construction/land loan. At December 31, 2018, construction/land loans included $25.2 million of multifamily loans, $10.0 million of commercial real estate loans and $602,000 of one-to-four family loans that roll over to permanent loans in accordance with the terms of the construction/land loan.

To assist in our strategic initiatives for loan growth and to achieve geographic diversification, the Bank will originate and purchase loans and utilize loan participations with the underlying collateral located within areas of Washington State outside our primary market area or in other states. The Bank's goal with respect to loan participations is to locate a selling bank that is unable to make an entire loan due to legal or lending concentration limitations. Sellers of these loans are reviewed for management/lending experience, financial condition, asset quality metrics, and regulatory matters. Loans acquired through participation or purchase must meet the Bank's underwriting standards. During the nine months ended September 30, 2019, the Bank purchased or participated in $41.8 million of loans that included $17.4 million of commercial real estate loans secured by properties located outside of Washington State, $8.7 million of construction/land loans secured by properties located in Washington state, and $15.0 million of consumer loans secured by classic/collectible automobiles, to borrowers located in Washington and other states.

The majority of our loan portfolio continues to be secured by properties located in our primary market area, however a significant amount is secured by properties in other areas of Washington, in California, and in other states. At September 30, 2019, total loans secured by collateral located in California represented 4.1% of our total loans and total loans secured by c ollateral located outside the states of California and Washington represented 10.8% of our total loans. The following table details geographic concentrations in our loan portfolio:

	At September 30, 2019						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/Land	Business	Consumer	Total
	(In thousands)						
King County	$ 291,015	$ 103,240	$ 190,049	$ 92,003	$ 13,104	$ 10,389	$ 699,800
Pierce County	33,478	5,111	25,533	11,952	325	585	76,984
Snohomish County	27,184	3,635	20,733	1,729	3,210	716	57,207
Kitsap County	5,125	1,472	763	2,249	—	—	9,609
Other Washington Counties 9,775	10,192	23,603	53,376	1,982	1,260	415	90,828
California	2,691	17,520	20,275	—	1,037	3,025	44,548
Outside Washington and California [(1)]	701	16,571	71,161	—	18,571	11,321	118,325
Total loans	$ 370,386	$ 171,152	$ 381,890	$ 109,915	$ 37,507	$ 26,451	$ 1,097,301

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(1) Includes loans in Utah, Arizona and Oregon of $16.2 million, $14.6 million and $12.0 million, respectively, and loans in 32 other states.

Our five largest borrowing relationships, which represent 7.8% of our net loans, increased by $5.4 million to $85.3 million at September 30, 2019, from $79.9 million at December 31, 2018. The total number of loans represented by this group of borrowers remained stable with 20 loans at September 30, 2019, and 19 loans at December 31, 2018. At September 30, 2019, all five borrowers were current on their loan payments. We monitor the performance of these borrowing relationships very closely due to their concentration risk in relation to the entire loan portfolio.

The following table details our five largest lending relationships at September 30, 2019:

Borrower (1)	Number of Loans	One-to-Four Family Residential (2)	Multifamily	Commercial Real Estate	Construction/Land	Consumer	Aggregate Balance of Loans
		(Dollars in thousands)					
Real estate investor	5	$ —	$ 8,491	$ 13,079	$ —	$ —	$ 21,570
Real estate investor	3	406	—	18,791	—	—	19,197
Real estate investor	6	436	—	16,286	—	348	17,070
Real estate investor	4	—	—	3,220	10,542	—	13,762
Real estate investor	2	—	7,234	6,477	—	—	13,711
Total	20	$ 842	$ 15,725	$ 57,853	$ 10,542	$ 348	$ 85,310

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

(2) All of the one-to-four family residential loans for these borrowers are for owner occupied properties. The commercial real estate loans are for non-owner occupied properties.

The ALLL decreased to $13.2 million at September 30, 2019, from $13.3 million at December 31, 2018, and represented 1.20% and 1.29% of total loans receivable at September 30, 2019, and December 31, 2018, respectively. The ALLL consists of two components, the general allowance and the specific reserves. The decrease in the ALLL was primarily the result of the Bank's loan concentrations shifting to lower risk loan types combined with a reduction in the ALLL for certain loan types reflecting the strength of collateral values and reduction in related risk. These reductions were partially offset by the ALLL required for the $59.9 million increase in total loans. Although impaired loans increased $8.2 million during the nine months ended September 30, 2019, this increase was primarily due to an $11.6 million construction loan reclassified to impaired and special mention status due to the loan not complying with the original terms of the loan. Because of additional collateral secured at the time of origination, the Bank's impairment analysis concluded there were no anticipated losses from the loan at this time and no additional reserve was determined to be required at September 30, 2019. For additional information, see "Comparison of Operating Results for the Nine Months Ended September 30, 2019 and 2018 - Provision for Loan Losses" discussed below.

We believe that the ALLL at September 30, 2019, was adequate to absorb the probable and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will be proven correct in the future, that the actual amount of future losses will not exceed the amount of past provisions, or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. Future additions to the allowance may become necessary based upon changing economic conditions, the level of problem loans, business conditions, credit concentrations, increased loan balances, or changes in the underlying collateral of the loan portfolio. In addition, the determination of the amount of our ALLL is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional loss reserves or the charge-off of specific loans against established loss reserves based upon their judgment of information available to them at the time of their examination.

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

The following table presents a breakdown of our TDRs at the dates indicated, all of which were performing:

	September 30, 2019	December 31, 2018	Nine Month Change
		(Dollars in thousands)	
Performing TDRs:			
One-to-four family residential	$ 4,475	$ 6,941	$ (2,466)
Commercial real estate	2,127	2,415	(288)
Consumer	—	43	(43)
Total performing TDRs	6,602	9,399	(2,797)
Total TDRs	$ 6,602	$ 9,399	$ (2,797)
% TDRs classified as performing	100.0%	100.0%	

Our TDRs decreased $2.8 million at September 30, 2019, compared to December 31, 2018, as a result of principal repayments and loan payoffs. At September 30, 2019, there were no TDRs on nonaccrual status. In addition, there were no committed but undisbursed funds in connection with our TDRs and impaired loans. The largest TDR relationship at September 30, 2019, totaled $1.3 million and was secured by a non-owner occupied commercial property located in King County.

Loans are considered past due if a scheduled principal or interest payment is due and unpaid for 30 days or more. At September 30, 2019, total past due loans declined to $321,000, representing 0.03% of total loans receivable, from $821,000, or 0.08% of total loans at December 31, 2018.

Nonperforming assets decreased by $644,000 during the first nine months of 2019, primarily as a result of payoffs of two nonaccrual loans totaling $597,000. The following table presents detailed information on our nonperforming assets at the dates indicated:

	September 30, 2019	December 31, 2018	Nine Month Change
		(Dollars in thousands)	
Nonperforming loans:			
One-to-four family residential	$ 98	$ 382	$ (284)
Commercial real estate	—	326	(326)
Consumer	39	44	(5)
Total nonperforming loans	137	752	(615)
OREO	454	483	(29)
Total nonperforming assets [1] [2]	$ 591	$ 1,235	$ (644)
Nonperforming assets as a percent of total assets	0.05%	0.10%	

[1] The difference between nonperforming assets reported above, and the totals reported by other industry sources, is due to their inclusion of all TDRs as nonperforming loans, although 100.0% of our TDRs were performing in accordance with their restructured terms at September 30, 2019.
[2] The $11.6 million impaired loan referenced in this document is not included in this table as all loan payments were current at September 30, 2019.

Nonaccrual loans are loans that are 90 days or more delinquent or other loans which, in management's opinion, the borrower is unable to meet scheduled payment obligations. The largest nonaccrual loan at September 30, 2019 was a $98,000 owner occupied, single-family residence located in Snohomish County. Also included in nonaccrual loans at September 30, 2019, was a $39,000 home equity second mortgage secured by a non-owner occupied, single-family residence in King County. At September 30, 2019, both of these loans were current on their loan payments.

We continue to focus our efforts on working with borrowers to bring their loans current or converting nonaccrual loans to OREO and subsequently selling the properties. By taking ownership of these properties, we can generally convert nonearning assets into earning assets on a more timely basis than which may otherwise be the case. Our success in this area is reflected by the low ratio of our nonperforming assets as a percent of total assets of 0.05% at September 30, 2019, and 0.10% at December 31, 2018, as well as the minimal amount of OREO held at September 30, 2019.

OREO. OREO includes properties acquired by the Bank through foreclosure or acceptance of a deed in lieu of foreclosure. At September 30, 2019, and December 31, 2018, OREO was $454,000 and $483,000, respectively, and consisted of two undeveloped commercial lots located in Pierce County. During the nine months ended September 30, 2019, a $29,000 write-down was recognized on these properties as the result of an updated valuation analysis.

Intangible assets. The balance of goodwill was $889,000 at both September 30, 2019 and December 31, 2018. Goodwill was calculated as the excess purchase price of the branches acquired in August 2017 (the “Branch Acquisition”) over the fair value of the assets acquired and liabilities assumed.

The core deposit intangible (“CDI”) recorded as part of the Branch Acquisition represents the fair value of the customer relationships on the acquired noninterest-bearing checking, interest-bearing checking, savings, and money market accounts. The CDI balance was $1.0 million at September 30, 2019 and $1.1 million at December 31, 2018. The initial ratio of CDI to the acquired balances of core deposits was 2.23%. This amount amortizes into noninterest expense on an accelerated basis over ten years.

Deposits. During the first nine months of 2019, deposits increased $77.8 million to $1.02 billion at September 30, 2019, compared to $939.0 million at December 31, 2018. Deposit accounts consisted of the following:

	September 30, 2019	Change from December 31, 2018	Percent Change
		(Dollars in thousands)	
Noninterest-bearing	$ 49,398	$ 3,290	7.1 %
Interest-bearing checking	53,197	13,118	32.7
Statement savings	21,647	(3,152)	(12.7)
Money market	332,722	(6,325)	(1.9)
Certificates of deposit, retail	421,274	30,100	7.7
Certificates of deposit, brokered	138,590	40,765	41.7
	$ 1,016,828	$ 77,796	8.3

Our retail deposits increased by $37.0 million during the nine months ended September 30, 2019. Retail certificates of deposit increased by $30.1 million as the Bank competitively priced these certificates to increase this funding source. In addition, continued emphasis on deposit growth at our branches resulted in a $13.1 million increase in interest-bearing checking accounts. Partially offsetting these increases, money market accounts declined by $6.3 million.

To further assist in our funding needs, our portfolio of brokered certificates of deposits increased by $40.8 million to $138.6 million at September 30, 2019, from $97.8 million at December 31, 2018. This increase was primarily the result of an opportunity to obtain short-term brokered deposits at interest rates lower than the cost of short-term FHLB advances. These funds were partially used to pay down the balance of the Bank's overnight borrowings. While brokered certificates of deposit may carry a higher cost than our retail certificates, their remaining maturity periods of up to 4.0 years, along with the enhanced call features on a portion of these deposits, assist us in our efforts to manage interest rate risk.

At September 30, 2019 and December 31, 2018, we held $30.0 million and $28.5 million in public funds, respectively, primarily in retail certificates of deposit and money market accounts.

Advances. We use advances from the FHLB as an alternative funding source to manage interest rate risk and to leverage our balance sheet. Total FHLB advances were $121.0 million at September 30, 2019, a $25.5 million decrease from $146.5 million at December 31, 2018. At September 30, 2019, the Bank had $86.0 million in borrowings that are due in less than one year and $35.0 million in borrowings that are due in less than three years. Our long-term advances at September 30, 2019, consisted of two Member Option Variable Rate advances that reprice quarterly and allow prepayment without penalties at the repricing date. The repayment option on our Member Option Variable Rate advances and short term nature of overnight FHLB advances provides us flexibility to adjust the level of our borrowings as our customer deposit balances grow, consistent with our asset/liability objectives. Our FHLB advances also include a $50.0 million fixed rate three-month advance that renews quarterly and a $15.0 million fixed rate one-month advance that renews monthly. Both of these borrowings renew at the fixed interest rate in effect on the renewal date and are designated as a cash flow hedge, as described below.

Cash Flow Hedge. To assist in managing interest rate risk, the Bank has entered into two five-year interest rate swap agreements which qualify as cash flow hedges with a qualified institution where the Bank pays a fixed rate for five years and, in turn, receives an interest payment based on a LIBOR index. The agreements allow for a substitute index to be used if LIBOR is unavailable.

On October 25, 2016, the Bank entered into a $50.0 million notional pay fixed, receive floating interest rate swap agreement where the Bank pays a fixed rate of 1.34% and, in turn, receives an interest payment based on three-month LIBOR index, which resets quarterly, for five years. Concurrently, the Bank borrowed a $50.0 million fixed rate three-month advance that is renewed quarterly. On September 27, 2019, the Bank entered into a $15.0 million notional pay fixed, receive floating interest rate swap agreement, where the Bank pays a fixed rate of 1.44% and, in turn, receives an interest payment based on one-month LIBOR index, which resets monthly, for five years. Concurrently, the Bank borrowed a $15.0 million fixed rate one-month FHLB advance that is renewed monthly.

A change in the net fair value of these cash flow hedges is recognized as an other asset or other liability on the balance sheet with the tax-effected portion of the change included in other comprehensive income. At September 30, 2019, we recognized a $213,000 net fair value asset as a result of the increase in the market value of these hedge agreements.

Stockholders' Equity. Total stockholders' equity increased $1.4 million during the first nine months of 2019 to $155.1 million at September 30, 2019, from $153.7 million at December 31, 2018. Increases to stockholders' equity, comprised of $7.8 million of net income, a $1.2 million reduction in other comprehensive loss, net of tax, as a result of improvements in the fair market value of our available-for-sale securities and $1.7 million of stock based compensation, were partially offset by a $6.8 million reduction due to the repurchase of 433,952 shares of common stock and $2.6 million in cash dividends paid. As part of the strategy to increase shareholder value, the Company's Board of Directors authorized a stock repurchase plan that began on November 5, 2018 which expired on May 3, 2019. The plan authorized the repurchase of up to 550,000 shares of the Company's stock of which all were repurchased during the term of the plan. From January 1, 2019 through May 3, 2019, 346,100 shares were repurchased under this plan at an average price of $15.89 per share. The Company's Board of Directors authorized an additional plan that began on July 30, 2019 and expires on December 17, 2019. This plan authorizes the repurchase of up to 520,000 shares. At September 30, 2019, 87,852 shares had been purchased under this plan at an average price of $14.05 per share.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Dividend declared per common share	$ 0.09	$ 0.08	$ 0.26	$ 0.23
Dividend payout ratio [1]	36.0%	29.6%	33.6%	18.6%

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[1] Dividends paid per common share divided by basic earnings per common share.

Comparison of Operating Results for the Three Months Ended September 30, 2019 and 2018

General. Net income for the three months ended September 30, 2019, was $2.5 million, or $0.25 per diluted share as compared to net income of $2.8 million, or $0.27 per diluted share for the three months ended September 30, 2018. The $287,000 decrease in net income during the three months ended September 30, 2019, was a combined result of a $407,000 decrease in net interest income and a $254,000 increase in noninterest expense, partially offset by a $100,000 decrease in the provision for loan losses, a $198,000 increase in noninterest income and a $76,000 decrease in federal income tax expense.

Net Interest Income. Net interest income for the three months ended September 30, 2019, decreased $407,000 to $9.7 million from $10.1 million for the three months ended September 30, 2018 primarily due to the increase in our cost of funds outpacing the increase in yield on our interest-earning assets.

Interest income increased by $1.3 million for the three months ended September 30, 2019, as compared to the same period in 2018, primarily as a result of a $92.3 million increase in the average balance of our interest-earning assets combined with a seven basis point increase in average yield. Average loans receivable increased by $80.0 million and average interest-earning deposits increased by $15.8 million. These increases were partially offset by a $553,000 decrease in investments available-for-sale as sales and principal pay downs outpaced purchases of new investments available-for-sale. In addition, the average balance of FHLB stock decreased by $2.9 million as our required investment decreased due to lower average outstanding FHLB advances.

The average yield on our interest-earning assets increased by seven basis points for the three months ended September 30, 2019 as compared to the same period in 2018, earning 4.84% and 4.77%, respectively. The average yield on our loan portfolio for the three months ended September 30, 2019 was 5.14%, as compared to a yield of 5.05% for the three months ended September 30, 2018. Contributing to this increase, the volume of variable rate loans increased to 54.1% at September 30, 2019, from 52.7% at September 30, 2018, with an increase in the minimum weighted average interest rate of 53 basis points.

Outpacing the increase in interest income, interest expense increased by $1.7 million for the three months ended September 30, 2019, as compared to the same period in 2018. The increase was primarily the result of increases in the cost of interest-bearing liabilities, in particular money market deposits and certificates of deposit. In response to market rate increases and our competitive pricing of retail certificates of deposit to increase this funding source, the average cost of our interest-bearing deposits increased by 60 basis points. The average cost of our borrowings remained stable with a slight decrease of three basis points for the three months ended September 30, 2019, as compared to the same period in 2018. Also contributing to the increase in interest expense during these periods, the average balance of our interest-bearing deposits increased by $173.1 million, with $88.7 million of this from growth in our retail operations and $84.4 million from an increase in average brokered certificates of deposit. Money market interest expense increased by $413,000 as a result of a 49 basis point increase in the average cost of these funds combined with a $4.4 million increase in the average balance of these deposits. The cost of retail and brokered certificates of deposit increased by 68 and 43 basis points, respectively, as compared to the same quarter last year as the rates needed to compete for growth in these deposits has increased and deposit repricing lags recent reductions in market rates due to decreases in the Federal Funds targeted rate. Further contributing to the increase in interest expense on brokered certificates of deposit, during the three months ended September 30, 2019, the Bank exercised the call option on $17.4 million of brokered certificates of deposit that had a weighted average rate of 3.17% and a remaining weighted maturity period of 2.4 years. This redemption resulted in the recognition of $60,000 in additional interest expense for the three months ended September 30, 2019, for unamortized fees related to the original acquisition of these brokered deposits. These funds were replaced with lower cost FHLB advances and a concurrent five-year, $15.0 million notional pay fixed, receive floating interest rate swap for which the Bank will pay 1.44% monthly and in exchange will receive variable rate amounts from the interest rate swap counter party based on one-month LIBOR. Based on current interest rates, this redemption is estimated to save the Bank in excess of $600,000 over the next 2.4 years compared to what would have been paid on the redeemed callable brokered deposits if the call options were not exercised. The growth in our retail and brokered deposits more than met our funding needs, allowing the Bank to pay down certain FHLB advances resulting in a $73.5 million decrease in the average balance of these borrowings for the three months ended September 30, 2019, as compared to the same period in 2018.

The Company’s net interest margin and interest rate spread decreased by 39 basis points and 41 basis points, respectively, primarily due to increases in our cost of funds as our interest-bearing liabilities generally reprice faster than our interest-earning assets in response to changes in market interest rates. For more information on this, see “How We Measure the Risk of Interest Rate Changes” in Item 3 of this report.

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

	Three Months Ended September 30, 2019 Compared to September 30, 2018 Net Change in Interest		
	Rate	**Volume**	**Total**
		(In thousands)	
Interest-earning assets:			
Loans receivable, net	$ 249	$ 1,017	$ 1,266
Investments available-for-sale	7	(4)	3
Interest-earning deposits with banks	23	76	99
FHLB stock	8	(46)	(38)
Total net change in income on interest-earning assets	287	1,043	1,330
Interest-bearing liabilities:			
Interest-bearing demand	5	5	10
Statement savings	—	(1)	(1)
Money market	400	13	413
Certificates of deposit, retail	734	328	1,062
Certificates of deposit, brokered	192	449	641
Advances from the FHLB	(8)	(380)	(388)
Total net change in expense on interest-bearing liabilities	1,323	414	1,737
Total net change in net interest income	$ (1,036)	$ 629	$ (407)

The following table compares detailed average balances, related interest income or interest expense, associated yields and rates, and the resulting net interest margin for the three months ended September 30, 2019 and 2018. Nonaccrual loans are included in the average balance of net loans receivable and are considered to carry a zero yield.

	Three Months Ended September 30,					
	2019			2018		
	Average Balance	Interest Earned / Paid	Yield / Cost	Average Balance	Interest Earned / Paid	Yield / Cost
	(Dollars in thousands)					
Assets						
Loans receivable, net	$ 1,073,283	$ 13,897	5.14%	$ 993,272	$ 12,631	5.05%
Investments available-for-sale	140,031	1,066	3.02	140,584	1,063	3.00
Interest-earning deposits with banks	27,992	158	2.24	12,223	59	1.92
FHLB stock	5,649	97	6.81	8,540	135	6.27
Total interest-earning assets	1,246,955	15,218	4.84	1,154,619	13,888	4.77
Noninterest earning assets	72,822			70,570		
Total average assets	$ 1,319,777			$ 1,225,189		
Liabilities and Stockholders' Equity						
Interest-bearing demand	$ 53,100	$ 31	0.23%	$ 42,090	$ 21	0.20%
Statement savings	21,979	7	0.13	25,376	8	0.13
Money market	321,502	1,314	1.62	317,089	901	1.13
Certificates of deposit, retail	422,755	2,541	2.38	346,065	1,479	1.70
Certificates of deposit, brokered	178,787	1,144	2.54	94,435	503	2.11
Total interest-bearing deposits	998,123	5,037	2.00	825,055	2,912	1.40
FHLB Advances	103,707	529	2.02	177,250	917	2.05
Total interest-bearing liabilities	1,101,830	5,566	2.00	1,002,305	3,829	1.52
Noninterest bearing liabilities	62,890			68,440		
Average equity	155,057			154,444		
Total average liabilities and equity	$ 1,319,777			$ 1,225,189		
Net interest income		$ 9,652			$ 10,059	
Net interest margin			3.07%			3.46%

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

During the three months ended September 30, 2019, management evaluated the adequacy of the ALLL and concluded that a $100,000 provision for loan losses was appropriate due primarily to a $31.0 million increase in total loans receivable. The increase in the ALLL required due to loan growth was partially offset by a reduction in the ALLL for certain loan types reflecting the strength of loan collateral values and reduction in related risk. In comparison, during the three months ended September 30, 2018, a $200,000 provision for loan losses was recognized primarily as a result of growth in net loans receivable, partially offset by recoveries received on loans previously charged off.

The following table summarizes selected financial data related to our ALLL and loan portfolio.

	At or For the Three Months Ended September 30,	
	2019	2018
	(Dollars in thousands)	
Total loans receivable, end of period	$ 1,097,301	$ 1,009,789
Average loans receivable during period	1,073,283	993,272
ALLL balance at beginning of period	13,057	12,754
Provision for loan losses	100	200
Charge-offs:		
Total charge-offs	—	—
Recoveries:		
One-to-four family	3	2
Construction/land development	—	160
Consumer	1	—
Total recoveries	4	162
Net recovery	4	162
ALLL balance at end of period	$ 13,161	$ 13,116
ALLL as a percent of total loans	1.20%	1.30%
Ratio of net recoveries to average net loans receivable	—	0.02

Noninterest Income. Noninterest income increased $198,000 to $1.0 million for the quarter ended September 30, 2019, from $841,000 for the quarter ended September 30, 2018. The following table provides a detailed analysis of the changes in the components of noninterest income:

	Three Months Ended September 30, 2019	Change from Three Months Ended September 30, 2018	Percent Change
		(Dollars in thousands)	
Net gain on sale of investments	$ 88	$ 87	8,700.0 %
BOLI change in cash surrender value	235	(10)	(4.1)
Wealth management revenue	245	100	69.0
Deposit related fees	179	12	7.2
Loan related fees	290	17	6.2
Other	2	(8)	(80.0)
Total noninterest income	$ 1,039	$ 198	23.5 %

During the three months ended September 30, 2019, as compared to the three months ended September 30, 2018, wealth management revenue increased by $100,000 as a result of an increase in the total assets managed by our wealth management division and regular fluctuations in the timing and mix of commissions received on serviced accounts. Sales of $1.7 million in municipal bonds during the three months ended September 30, 2019 resulted in an additional $87,000 gain on sales of investments during this period as compared to the same period in 2018. In addition, loan related fees increased by $17,000, primarily as a result of interest rate swap fees received on loans where certain commercial loan customers participate in an interest rate swap with a third party broker institution and the Bank receives a fee that is recognized as other noninterest income at the time the loan is originated.

Noninterest Expense. Noninterest expense increased $254,000 to $7.5 million for the three months ended September 30, 2019, from $7.2 million for the comparable period in 2018.

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

	Three Months Ended September 30, 2019	Change from Three Months Ended September 30, 2018	Percent Change
		(Dollars in thousands)	
Salaries and employee benefits	$ 4,813	$ 81	1.7 %
Occupancy and equipment	924	110	13.5
Professional fees	440	87	24.6
Data processing	478	122	34.3
OREO related expenses, net	1	—	—
Regulatory assessments	13	(113)	(89.7)
Insurance and bond premiums	95	—	—
Marketing	118	33	38.8
Other general and administrative	573	(66)	(10.3)
Total noninterest expense	$ 7,455	$ 254	3.5 %

Continued growth and branch expansion for the Company contributed to an increase in salary and employee benefits of $81,000, occupancy and equipment of $110,000 and data processing services of $122,000, for the three months ended September 30, 2019, as compared to the same period in 2018. As the Company continues to expand its market presence, we expect these expenses to increase accordingly. Partially offsetting the increases during the three months ended September 30, 2019, regulatory assessments decreased by $113,000 as a portion of the Bank's small bank assessment credit was applied for previously paid deposit insurance premiums as a result of the FDIC exceeding its stated Deposit Insurance Fund Reserve Ratio. The Company has $124,000 in credits on future assessments remaining as of September 30, 2019, which may be recognized in future periods when allowed for by the FDIC upon insurance fund levels being met.

Federal Income Tax Expense. The federal income tax provision decreased by $76,000 to $631,000 for the three months ended September 30, 2019, as compared to $707,000 for the same period in 2018, primarily due to a $363,000 decrease in pretax net income.

Comparison of Operating Results for the Nine Months Ended September 30, 2019 and 2018

General. Net income for the nine months ended September 30, 2019 was $7.8 million, or $0.77 per diluted share as compared to net income of $12.7 million, or $1.22 per diluted share for the nine months ended September 30, 2018. The decrease during the nine months ended September 30, 2019, was primarily the result of a $2.0 million decrease in net interest income and a $3.9 million reduction in the recapture of loan loss provision, partially offset by a $1.1 million decrease in federal income tax expense.

Net Interest Income. Net interest income for the nine months ended September 30, 2019 was $29.2 million, as compared to $31.2 million for the same period in 2018, primarily due to the increase in our cost of funds outpacing the increase in yield on our interest-earning assets.

Interest income increased by $3.1 million for the nine months ended September 30, 2019, as compared to the same period in 2018, primarily as a result of a $58.8 million increase in the average balance of our interest-earning assets combined with a 10 basis point increase in average yield. Increases in average loans receivable of $60.5 million and average interest-earning deposits of $2.4 million were partially offset by a $1.6 million decrease in average investments available-for-sale. In addition, the average balance of FHLB stock decreased by $2.4 million as our required investment activity stock decreased due to lower average outstanding FHLB advances.

Also contributing to the increase in interest income, the average yield on our loan portfolio for the nine months ended September 30, 2019 was 5.18%, as compared to an average yield of 5.14% for the nine months ended September 30, 2018. In addition, the average yield on our investment securities increased by 35 basis points and the average yield on our interest-earning deposits increased by 69 basis points for the nine months ended September 30, 2019 as compared to the same period in 2018.

Outpacing the increase in interest income, interest expense increased by $5.0 million for the nine months ended September 30, 2019, as compared to the same period in 2018. The increase was primarily the result of increases in the cost of interest-bearing liabilities, in particular money market deposits and certificates of deposit. In response to market rate increases and our competitively pricing retail certificates of deposit to increase this funding source, the average cost of our interest-bearing deposits increased by 63 basis points and the average cost of our FHLB advances increased by 34 basis points for the nine months ended September 30, 2019, as compared to the same period in 2018. Also contributing to the increase in interest expense during these periods, the average balance of our interest-bearing deposits increased by $122.8 million, with $67.7 million of this from growth in our retail operations and $55.1 million from an increase in average brokered certificates of deposit. Money market interest expense increased by $1.1 million as a result of a 47 basis point increase in the average cost of these funds partially offset by a $7.5 million decrease in the average balance of these deposits. The cost of retail and brokered certificates of deposit increased by 77 and 57 basis points, respectively, as compared to the same period last year as the rates needed to compete for growth in these deposits increased and deposit repricing lags recent reductions in market rates due to decreases in the Federal Funds targeted rate. The cost of brokered certificates of deposits was further impacted by the Bank's exercise of the call option on $17.4 million of brokered deposits during the nine months ended September 30, 2019, resulting in recognition of $60,000 additional interest expense for unamortized fees relating to their original acquisition as discussed above. The growth in our retail and brokered deposits more than met our funding needs, allowing the Bank to pay down certain FHLB advances resulting in a $63.1 million decrease in the average balance of these borrowings for the nine months ended September 30, 2019, as compared to the same period in 2018.

Generally, our interest-bearing liabilities reprice faster than our interest-earning assets in response to changes in market interest rates, resulting in a decrease in our net interest margin of 39 basis points to 3.22% for the nine months ended September 30, 2019 as compared 3.61% for the nine months ended September 30, 2018. Further contributing to the decrease year-over-year, the additional $1.0 million in loan interest received early in 2018 from the repayment of balances on previously charged off loans contributed to the net interest margin for the nine months ended September 30, 2018. For more information on this, see "How We Measure the Risk of Interest Rate Changes" in Item 3 of this report.

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

	Nine Months Ended September 30, 2019 Compared to September 30, 2018 Net Change in Interest		
	Rate	Volume	Total
		(In thousands)	
Interest-earning assets:			
Loans receivable, net	$ 358	$ 2,323	$ 2,681
Investments available-for-sale	366	(34)	332
Interest-earning deposits with banks	77	28	105
FHLB stock	36	(89)	(53)
Total net change in income on interest-earning assets	837	2,228	3,065
Interest-bearing liabilities:			
Interest-bearing demand	(3)	14	11
Statement savings	—	(3)	(3)
Money market	1,125	(58)	1,067
Certificates of deposit, retail	2,334	793	3,127
Certificates of deposit, brokered	586	778	1,364
Advances from the FHLB	344	(883)	(539)
Total net change in expense on interest-bearing liabilities	4,386	641	5,027
Total net change in net interest income	$ (3,549)	$ 1,587	$ (1,962)

The following table compares detailed average balances, associated yields and rates, and the resulting changes in interest and dividend income or expense for the nine months ended September 30, 2019 and 2018. Nonaccrual loans are included in the average balance of net loans receivable and are considered to carry a zero yield.

	Nine Months Ended September 30,					
	2019			2018		
	Average Balance	Interest Earned / Paid	Yield or Cost	Average Balance	Interest Earned / Paid	Yield or Cost
	(Dollars in thousands)					
Assets						
Loans receivable, net	$ 1,052,541	$ 40,784	5.18%	$ 992,071	$ 38,103	5.14%
Investments available-for-sale	139,698	3,334	3.19	141,279	3,002	2.84
Interest-earning deposits with banks	14,329	246	2.30	11,957	141	1.58
FHLB stock	6,950	290	5.58	9,375	343	4.89
Total interest-earning assets	1,213,518	44,654	4.92	1,154,682	41,589	4.82
Noninterest earning assets	72,753			69,659		
Total average assets	$ 1,286,271			$ 1,224,341		
Liabilities and Stockholders' Equity						
Interest-bearing demand	$ 48,976	$ 72	0.02%	$ 39,714	$ 61	0.21%
Statement savings	23,153	23	0.13	26,319	26	0.13
Money market	316,348	3,558	1.50	323,865	2,491	1.03
Certificates of deposit, retail	407,893	7,015	2.30	338,757	3,888	1.53
Certificates of deposit, brokered	136,954	2,521	2.46	81,873	1,157	1.89
Total interest-bearing deposits	933,324	13,189	1.89	810,528	7,623	1.26
FHLB advances	136,641	2,255	2.21	199,769	2,794	1.87
Total interest-bearing liabilities	1,069,965	15,444	1.93	1,010,297	10,417	1.38
Noninterest bearing liabilities	62,906			64,184		
Average equity	153,400			149,860		
Total average liabilities and equity	$ 1,286,271			$ 1,224,341		
Net interest income		$ 29,210			$ 31,172	
Net interest margin			3.22%			3.61%

Provision for Loan Losses. During the nine months ended September 30, 2019, management evaluated the adequacy of the ALLL and concluded that a recapture of provision for loan losses in the amount of $300,000 was appropriate for the period. The recapture for the nine months ended September 30, 2019, was primarily the result of a construction loan with a balance of $11.6 million that was technically in default and classified as impaired, however, the Bank's impairment analysis concluded there were no anticipated losses from the loan at this time, and therefore, funds previously allocated in the ALLL to this loan were recaptured. All payments on the loan were current as of September 30, 2019, and the loan is well collateralized. In addition, total loans receivable increased by $59.9 million during the period, however the impact to the provision from the increased balance was offset by a shift in our loan concentrations to lower risk categories and reduction in the risk factor related to the collateral on certain loan types. In comparison, the $4.2 million recapture of provision for loan losses for the nine months ended September 30, 2018, was primarily a result of $4.4 million of recoveries received on previously charged off loans. In addition, a shift in our loan concentrations resulted in increased balances in lower risk categories during that period.

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

	At or For the Nine Months Ended September 30,	
	2019	2018
	(Dollars in thousands)	
Total loans receivable, end of period	$ 1,097,301	$ 1,009,789
Average loans receivable during period	1,052,541	992,071
ALLL balance at beginning of period	13,347	12,882
Recapture of provision for loan losses	(300)	(4,200)
Charge-offs:		
Total charge-offs	—	—
Recoveries:		
One-to-four family	31	4,248
Multifamily	45	—
Commercial real estate	—	14
Construction/land development	—	172
Consumer	38	—
Total recoveries	114	4,434
Net recovery	114	4,434
ALLL balance at end of period	$ 13,161	$ 13,116
ALLL as a percent of total loans	1.20%	1.30%
Ratio of net recoveries to average net loans receivable	0.01	0.45

Noninterest Income. Noninterest income increased by $468,000 to $2.6 million for the nine months ended September 30, 2019, as compared to $2.2 million for the same period in 2018. The following table provides a detailed analysis of the changes in the components of noninterest income:

	Nine Months Ended September 30, 2019	Change from Nine Months Ended September 30, 2018	Percent Change
	(Dollars in thousands)		
Net gain on sale of investments	$ 80	$ 100	(500.0)%
BOLI change in cash surrender value	693	(25)	(3.5)
Wealth management revenue	702	302	75.5
Deposit related fees	555	52	10.3
Loan related fees	562	29	5.4
Other	26	10	62.5
Total noninterest income	$ 2,618	$ 468	21.8 %

The primary increase in our noninterest income was from wealth management revenue, as a result of growth in assets managed for the comparative periods. This sector of our business allows us to meet the needs of our customers with a variety of deposit and investment options. Also contributing to the increase in noninterest income, sales of investment securities generated a net gain of $80,000 for the nine months ended September 30, 2019 as compared to a $20,000 net loss for the nine months ended September 30, 2018.

Deposit related fees increased $52,000 for the nine months ended September 30, 2019 as compared to the same period in 2018 primarily due to increased debit card and other transactional fees. Loan related fees increased $29,000 for these comparative periods primarily due to a $117,000 increase in interest rate swap fees received on loans where certain commercial loan customers participate in an interest rate swap with a third party broker institution and the Bank receives a fee that is recognized as other noninterest income at the time the loan is originated. This increase was partially offset by a decrease in annual and other fees received on certain loan types.

During the nine months ended September 30, 2019, the Bank purchased $379,000 of certain new BOLI polices where administrative fees are deducted at the origination of these policies, resulting in a $25,000 decrease in noninterest income as compared to the nine months ended September 30, 2018.

Noninterest Expense. Noninterest expense increased $732,000 to $22.4 million for the nine months ended September 30, 2019, as compared to $21.7 million for the same period in 2018.

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

	Nine Months Ended September 30, 2019	Change from Nine Months Ended September 30, 2018	Percent Change
	(Dollars in thousands)		
Salaries and employee benefits	$ 14,547	$ 222	1.5 %
Occupancy and equipment	2,688	276	11.4
Professional fees	1,262	139	12.4
Data processing	1,393	362	35.1
OREO-related expenses, net	33	29	725.0
Regulatory assessments	286	(105)	(26.9)
Insurance and bond premiums	288	(67)	(18.9)
Marketing	280	11	4.1
Other general and administrative	1,670	(135)	(7.5)
Total noninterest expense	$ 22,447	$ 732	3.4 %

The primary contributor to the increase in noninterest expense was our branch expansion over the past year. Salaries and employee benefits expense increased by $222,000 for the nine months ended September 30, 2019, as compared to the nine months ended September 30, 2018, due to increased staffing in support of the new branches and development of new products. In addition, occupancy and equipment expenses increased by $276,000 with our growth to eleven locations at September 30, 2019. Further, data processing expense increased by $362,000 as a combined result of increased loan and deposit volume, and the addition of new services to better serve our customers.

Partially offsetting these increases, regulatory assessments decreased by $105,000 as the small bank assessment credit was applied for previously paid deposit insurance premiums as a result of the FDIC exceeding its stated Deposit Insurance Fund Reserve Ratio. Also reducing noninterest expense, insurance and bond premiums decreased by $67,000 as a result of higher BOLI expenses recognized for certain BOLI policies purchased in 2018. As a further decrease to our noninterest expense, other general and administrative expenses decreased by $135,000 for the nine months ended September 30, 2019 as compared to the same period in 2018, primarily as a result of a $125,000 insurance reimbursement received on a previously reported $225,000 fraud loss.

Federal Income Tax Expense. Income before federal income taxes decreased by $6.1 million for the nine months ended September 30, 2019, as compared to the same period in 2018, resulting in a reduction in federal income tax expense of $1.1 million. Partially offsetting the change from pretax net income, during the nine months ended September 30, 2018, the exercise of certain stock options resulted in a tax benefit, thereby reducing the effective tax rate for that period. In comparison, no stock options were exercised during the comparative period in 2019.

Liquidity

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

Our primary sources of funds are customer deposits, cash flow from the loan and investment portfolios, advances from the FHLB, and brokered certificates of deposit. These funds, together with equity, are used to make loans, acquire investment securities and other assets, and fund continuing operations. At September 30, 2019, retail certificates of deposit of $137.8 million and brokered certificates of deposit of $121.2 million were scheduled to mature in one year or less. Management's practice is to maintain deposit rates at levels that are competitive with other local financial institutions. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by the level of interest rates, economic conditions and competition. We measure our liquidity based on our ability to fund our assets and to meet liability obligations when they come due. Liquidity (and funding) risk occurs when funds cannot be raised at reasonable prices or in a reasonable time frame to meet our normal or unanticipated obligations. We regularly monitor the mix between our assets and our liabilities to manage effectively our liquidity and funding requirements.

When deposits are not readily available and/or cost effective to provide the funds for our assets, we use alternative funding sources. These sources include, but are not limited to: advances from the FHLB or the FRB, which are collateral dependent, wholesale funding, national certificates of deposit listing services, brokered deposits, federal funds purchased and dealer repurchase agreements, as well as other short-term alternatives. We may also liquidate assets to meet our funding needs. The balance of our investments available-for-sale decreased $3.9 million to $138.2 million at September 30, 2019, from December 31, 2018, and represents a ready source of cash if needed. The balance of our interest-earning deposits with banks decreased by $2.8 million to $6.1 million at September 30, 2019, from December 31, 2018, as a result of fluctuations in our funding needs for loans receivable and retail deposits. At September 30, 2019, the Bank maintained credit facilities with the FHLB totaling $583.7 million, with an outstanding balance of $121.0 million. As further funding sources, we also had the ability to borrow $90.6 million from the FRB and $35.0 million from lines of credit with other financial institutions, with no balance outstanding at September 30, 2019. For additional information, see the Consolidated Statements of Cash Flows in Item 1 of this Form 10-Q.

To assist in our funds acquisition and interest rate risk management efforts, management utilizes the national brokered deposit market and maintained a balance at September 30, 2019, of $138.6 million of brokered certificates of deposit. In contrast to most retail certificate of deposit offerings which provide the depositor with an option to withdraw their funds prior to maturity, subject to an early withdrawal penalty, certificates of deposit acquired in the brokered market limits the depositor ability to withdraw the funds before the end of the term (except in the case of death or adjudication of incompetence of a depositor) which greatly reduces early redemption risk compared to retail deposits. This strategy may include, but is not necessarily limited to, raising longer term deposits (with terms greater than three years) that assist the Bank in its interest rate risk management efforts. At September 30, 2019, brokered certificates of deposit had a remaining maturity of up to 4.0 years. Some of these certificates also provide the Bank the option to redeem the deposit after six months, a favorable distinction compared to retail certificate of deposit terms that are offered in our local market. With these redemption limitations and call features, the cost of these brokered deposits is generally higher than our retail certificate of deposit offerings. Consequently, if we increase our brokered deposits, our cost of funds may increase.

First Financial Northwest is a separate legal entity from the Bank and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. First Financial Northwest's primary sources of funds consist of dividends from the Bank, although there are regulatory requirements related to the ability of the Bank to pay dividends. At September 30, 2019, the Company (on an unconsolidated basis) had liquid assets of $17.5 million and short-term liabilities of $247,000.

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

Commitments and Off-Balance Sheet Arrangements

We are a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and the unused portions of lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements. Commitments to extend credit and lines of credit are not recorded as an asset or liability by us until the instrument is exercised. At September 30, 2019 and December 31, 2018, we had no commitments to originate loans for sale.

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

The following table summarizes our outstanding commitments to originate loans, advance additional amounts pursuant to outstanding lines of credit and to disburse funds related to our construction loans at September 30, 2019:

	Total Amounts Committed	Amount of Commitment Expiration: Through One Year	After One Through Three Years	After Three Through Five Years	After Five Years
	(In thousands)				
Commitments to originate loans	$ 3,534	$ 3,304	$ 230	$ —	$ —
Unused portion of lines of credit	36,051	8,640	8,725	2,662	16,024
Undisbursed portion of construction loans	88,106	50,173	37,933	—	—
Total commitments	$ 127,691	$ 62,117	$ 46,888	$ 2,662	$ 16,024

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

As of September 30, 2019, the Bank had ten operating leases with remaining terms of 11 months to 6 years which carry minimum lease payments of $52,000 per month. All ten leases offer extension periods, and include a new leased branch in Kent, Washington, which opened in the first quarter of 2019, as well as a new lease secured for a branch office expected to open in the fourth quarter of 2019 in Kirkland, Washington.

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

Capital

At September 30, 2019, stockholders' equity totaled $155.1 million, or 11.9% of total assets. Our book value per share of common stock was $15.06 at September 30, 2019, compared to $14.35 at December 31, 2018. Consistent with our goal to operate a sound and profitable financial organization, we actively seek to maintain a "well-capitalized" status in accordance with regulatory standards.

As of September 30, 2019, the Bank exceeded all regulatory capital requirements and was considered "well capitalized" under regulatory capital guidelines of the FDIC. Effective September 30, 2018, the Company is no longer required to file consolidated capital ratios as part of the Federal Reserve Bank's regulatory filings. The following table provides the Bank's capital requirements and actual results.

	At September 30, 2019: Actual		For Minimum Capital Adequacy Purposes		To be Categorized as "Well Capitalized"	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
Tier I leverage capital (to average assets)	$ 133,458	10.13%	$ 52,724	4.00%	$ 65,904	5.00%
Common equity tier I ("CET1") (to risk-weighted assets)	133,458	13.14	45,702	4.50	66,015	6.50
Tier I risk-based capital (to risk-weighted assets)	133,458	13.14	60,937	6.00	81,249	8.00
Total risk-based capital (to risk-weighted assets)	146,164	14.39	81,249	8.00	101,561	10.00

In addition to the minimum CET1, Tier I total capital and leverage ratios, the Bank is required to maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. At September 30, 2019, the Bank's capital conservation buffer was 6.39%.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

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

The Committee also reviews current and projected liquidity needs. As part of its procedures, the Committee regularly reviews interest rate risk by forecasting the impact that changes in interest rates may have on net interest income and the market value of portfolio equity, which is defined as the net present value of an institution's existing assets, liabilities and off-balance sheet instruments and evaluating such impacts against the maximum potential change in the market value of portfolio equity that is authorized by the Board of Directors.

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

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

- we are originating shorter term higher yielding loans, whenever possible;
- we have attempted, where possible, to extend the maturities of our deposits which typically fund our long-term assets;
- we have invested in securities with relatively short average lives, generally less than eight years;
- we have added adjustable-rate loans to our loan portfolio;
- we utilize brokered certificates of deposit with a call option as a funding source; and
- we have utilized interest rate swaps to effectively fix the rate on certain FHLB advances.

We have evaluated the use of derivative instruments to limit the impact of interest rate changes on earnings, prepayment penalties and cash flows and to lower our cost of borrowing while taking into account variable interest rate risk. We are using interest rate swaps which qualify as a cash flow hedge as a tool to lower the cost of certain FHLB advances as compared to the fixed rates offered by the FHLB for its longer term advances. At September 30, 2019, pursuant to the interest rate swap agreement the Bank held a $50.0 million notional pay fixed, receive floating interest rate swap agreement with an effective rate of 1.34%, and a $15.0 million notional pay fixed, receive floating interest rate swap agreement with an effective rate of 1.44%. On both of these interest rate swap agreements, the Bank pays a fixed rate for five years and in turn, receives an interest payment based on the LIBOR index that resets on the same cycle as the hedged FHLB advance. Entering into these agreements has allowed the Bank to secure fixed rate funding at a lower cost than a traditional five-year fixed rate FHLB advance. We will continue to review similar instruments and may utilize them for interest rate risk management in the future.

Interest rate contracts, however, may expose us to the risk of loss associated with variations in the spread between the interest rate contract and the hedged item. In addition, these contracts carry volatility risk that the expected uncertainty relating to the price of the underlying asset differs from what is anticipated. If any interest rate swap we enter into proves ineffective, it could result in volatility in our operating results, including potential losses, which could have a material adverse effect on our results of operations and cash flows.

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

How We Measure the Risk of Interest Rate Changes. We monitor our interest rate sensitivity on a quarterly basis by measuring the impact of changes to net interest income in multiple rate environments. Management retains the services of a third party consultant with nearly 40 years of experience in asset-liability management to assist in its interest rate risk and asset-liability management. Management uses various assumptions to evaluate the sensitivity of the market value of our assets and liabilities to changes in interest rates. Although management believes these assumptions are reasonable, the interest rate sensitivity of our assets and liabilities on net interest income and the market value of portfolio equity could vary substantially if different assumptions were used or actual results differ from these assumptions. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react differently to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities lag behind changes in market interest rates. Non-uniform changes and fluctuations in market interest rates across various maturities will also affect the results presented. In addition, certain assets, such as adjustable-rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, a portion of our adjustable-rate loans have interest rate floors below which the loan's contractual interest rate may not adjust in conjunction with market rates. Approximately 54.1% of our total loans were adjustable-rate loans at September 30, 2019. At that date, $332.9 million, or 56.1% of these loans were at their floor, with a weighted-average interest rate of 4.78%.

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

The assumptions we use are based upon a combination of proprietary and market data that reflect historical results and current market conditions. These assumptions relate to interest rates, loan prepayments, deposit decay rates and the market value of certain assets under the various interest rate scenarios. We use market data to determine prepayments and maturities of loans, investments and borrowings and use our own assumptions on deposit decay rates except for time deposits. Time deposits are modeled to reprice to market rates upon their stated maturities. We also assume that non-maturity deposit rates can be maintained with rate adjustments proportionate to the change in market interest rates, based upon our historical deposit decay rates, which are substantially lower than market decay rates. We have observed in the past that our deposit accounts during changing rate environments have relatively lower volatility and less than market rate changes. When interest rates rise, we do not have to raise interest rates proportionately on less rate sensitive accounts to retain these deposits. These assumptions are based upon our analysis of our customer base, competitive factors and historical experience.

Our income simulation model examines changes in net interest income in which interest rates were assumed to remain at their base level, instantaneously increase by 100, 200 and 300 basis points or decline immediately by 100 basis points. A decline by 200 or 300 basis points were not reported as the current targeted federal funds rate is between 1.75% and 2.00%.

The following table illustrates the estimated change in our net interest income over the next 12 months from September 30, 2019, that would occur in the event of an immediate change in interest rates equally across all maturities, with no effect given to any steps that the Bank might take to counter the effect of that interest rate movement.

Net Interest Income Change at September 30, 2019

Basis Point Change in Rates	Net Interest Income	% Change
	(Dollars in thousands)	
+300	$ 36,786	(1.51)%
+200	36,946	(1.08)
+100	37,122	(0.61)
Base	37,351	—
(100)	38,009	1.76

The following table illustrates the change in our net portfolio value ("NPV") at September 30, 2019, that would occur in the event of an immediate change in interest rates equally across all maturities, with no effect given to any steps that we might take to counter the effect of that interest rate movement.

Basis Point Change in Rates	Net Portfolio Value [1]			Net Portfolio as % of Portfolio Value of Assets		Market Value of Assets [5]
	Amount	$ Change [2]	% Change	NPV Ratio [3]	% Change [4]	
			(Dollars in thousands)			
+300	$ 107,447	$ (32,102)	(23.00)%	8.86%	(2.46)%	$ 1,213,151
+200	118,351	(21,198)	(15.19)	9.53	(1.63)	1,242,299
+100	130,651	(8,898)	(6.38)	10.26	(0.68)	1,273,822
Base	139,549	—	—	10.71	—	1,302,695
(100)	144,353	4,804	3.44	10.87	0.37	1,327,872

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[1] The net portfolio value is the difference between the present value of the discounted cash flows of assets and liabilities and represents the market value of the Company's equity for any given interest rate scenario. Net portfolio value is useful for determining, on a market value basis, how the market value of equity changes in response to various interest rate scenarios. Large changes in net portfolio value reflect increased interest rate sensitivity and generally more volatile earnings streams.

[2] The increase or decrease in net portfolio value at the indicated interest rates compared to the net portfolio value assuming no change in interest rates.

[3] Net portfolio value divided by the market value of assets.

[4] The increase or decrease in the net portfolio value divided by the market value of assets.

[5] The market value of assets represents the value of assets under the various interest rate scenarios and reflects the sensitivity of those assets to interest rate changes.

The net interest income and net portfolio value tables presented above are predicated upon a stable balance sheet with no growth or change in asset or liability mix. In addition, the net portfolio value is based upon the present value of discounted cash flows using our estimates of current replacement rates to discount the cash flows. The effects of changes in interest rates in the net interest income table are based upon a cash flow simulation of our existing assets and liabilities and assuming that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. Delinquency rates may change when interest rates change as a result of changes in the loan portfolio mix, underwriting conditions, loan terms or changes in economic conditions that have a delayed effect on the portfolio. Even if interest rates change in the designated amounts, there can be no assurance that our assets and liabilities would perform as set forth above. Also, a change in U.S. Treasury rates in the designated amounts accompanied by a change in the shape of the Treasury yield curve would cause changes to the net portfolio value and net interest income other than those indicated above.

At September 30, 2019, other than the interest rate swap agreements we have entered into, we did not have any derivative financial instruments or trading accounts for any class of financial instruments, nor have we engaged in any other hedging activities or purchased off-balance sheet derivative instruments. However, we continue to review such instruments and may utilize them for interest rate risk management in the future. Interest rate risk continues to be one of our primary risks, as other types of risks, such as foreign currency exchange risk and commodity pricing risk do not arise in the normal course of our business activities and operations.

Item 4. Controls and Procedures

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

(a) *Evaluation of Disclosure Controls and Procedures:* An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer (Principal Financial Officer) and several other members of our senior management as of the end of the period covered by this report. Our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2019, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) *Changes in Internal Controls:* In the quarter ended September 30, 2019, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in Part I, Item 1A of our 2018 Form 10-K.

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

(a) Not applicable

(b) Not applicable

(c) The following table summarizes First Financial Northwest's common stock repurchases during the three months ended September 30, 2019, under the repurchase plan effective July 30, 2019 through December 17, 2019:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Repurchased as Part of Publicly Announced Plan	Maximum Number of Shares that May Yet Be Repurchased Under the Plan
July 1 - July 31, 2019	—	$ —	—	520,000
August 1 - August 31, 2019	61,652	14.06	61,652	458,348
September 1 - September 30, 2019	26,200	14.01	26,200	432,148
	87,852	14.05	87,852	432,148

On July 25, 2019, the Board of Directors authorized the repurchase of up to 520,000 shares of the Company's common stock, or approximately 5% of the Company's outstanding shares. The plan allowed for the repurchase from July 30, 2019 through December 17, 2019, on the open market or in privately negotiated transactions, in accordance with Rule 10b-18 of the Securities and Exchange Act of 1934, as amended. At September 30, 2019, the Company had repurchased 87,852 shares authorized for repurchase at an average price of $14.05 per share.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits and Financial Statement Schedules

(a) Exhibits

3.1	Articles of Incorporation of First Financial Northwest [(1)]
3.2	Amended and Restated Bylaws of First Financial Northwest [(2)]
4.0	Form of stock certificate of First Financial Northwest [(1)]
10.1	Amended Employment Agreement between First Savings Bank Northwest and Joseph W. Kiley III [(3)]
10.2	Form of Change in Control Severance Agreement for Executive Officers [(4)]
10.3	Amended Executive Supplemental Retirement Plan Participation Agreement with Joseph W. Kiley III [(5)]
10.4	2008 Equity Incentive Plan [(6)]
10.5	2016 Equity Incentive Plan [(7)]
10.6	Forms of incentive and non-qualified stock option award agreements under the 2008 Equity Incentive Plan [(8)]
10.7	Form of restricted stock award agreement under the 2008 Equity Incentive Plan [(8)]
10.8	Employment Agreement between First Savings Bank Northwest and Richard P. Jacobson [(3)]
10.9	Form of restricted stock award agreement under the 2016 Equity Incentive Plan [(9)]
10.10	Form of incentive stock option award agreement under the 2016 Equity Incentive Plan [(10)]
10.11	Form of non-qualified stock option award agreement under the 2016 Equity Incentive Plan [(10)]
10.12	Form of restricted stock award agreement under the 2016 Equity Incentive Plan [(11)]
10.13	Offer letter for Randy T. Riffle [(12)]
10.14	Form of Involuntary Termination Agreement with Randy T. Riffle [(13)]
10.15	Form of Change in Control Severance Agreement with Randy T. Riffle [(13)]
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act
101	The following materials from First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2019, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements.

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(1) Filed as an exhibit to First Financial Northwest's Registration Statement on Form S-1 on June 6, 2007 (333-143539)
(2) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated September 26, 2019.
(3) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 5, 2013.
(4) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated September 9, 2014.
(5) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated July 11, 2017.
(6) Filed as Appendix A to First Financial Northwest's definitive proxy statement dated April 15, 2008.
(7) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated June 15, 2016.
(8) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated July 1, 2008.
(9) Filed as an exhibit to First Financial Northwest's Quarterly Report on Form 10-Q for March 31, 2018 filed on May 8, 2018.
(10) Filed as an exhibit to First Financial Northwest's Registration Statement on Form S-8 on June 15, 2016 (333-212029)
(11) Filed as an exhibit to First Financial Northwest's Quarterly Report on Form 10-Q for September 30, 2018 filed November 7, 2018.
(12) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated December 20, 2018.
(13) Filed as an exhibit to First Financial Northwest's Current Report on Form 8-K dated January 3, 2019.

SIGNATURES

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

FIRST FINANCIAL NORTHWEST, INC.

Date: November 8, 2019	By:	/s/ Joseph W. Kiley III
		Joseph W. Kiley III
		President and Chief Executive Officer (Principal Executive Officer)
Date: November 8, 2019	By:	/s/ Richard P. Jacobson
		Richard P. Jacobson
		Executive Vice President and Chief Financial Officer (Principal Financial Officer)
Date: November 8, 2019	By:	/s/ Christine A. Huestis
		Christine A. Huestis
		Vice President and Controller (Principal Accounting Officer)

Exhibit Index

Exhibit No.	Description
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act
101	The following materials from First Financial Northwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2019, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) Consolidated Income Statements; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Selected Notes to Consolidated Financial Statements.

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Section 2: EX-31.1 (EXHIBIT 31.1)

Exhibit 31.1

**Certification of Chief Executive Officer Pursuant to
Section 302 of the Sarbanes-Oxley Act of 2002**

I, Joseph W. Kiley III, certify that:

1. I have reviewed this quarterly report on Form 10-Q of First Financial Northwest, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2019

/s/Joseph W. Kiley III

Joseph W. Kiley III
President and Chief Executive Officer
(Principal Executive Officer)

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Section 3: EX-31.2 (EXHIBIT 31.2)

Exhibit 31.2

Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Richard P. Jacobson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of First Financial Northwest, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2019

/s/Richard P. Jacobson

Richard P. Jacobson
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

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Section 4: EX-32 (EXHIBIT 32)

Exhibit 32

Certification of Chief Executive Officer and Chief Financial Officer of First Financial Northwest, Inc.
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350), the undersigned hereby certifies in his/her capacity as an officer of First Financial Northwest, Inc. (the "Company") and in connection with this quarterly report on Form 10-Q for the period ending September 30, 2019, that:

1. the report fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended; and

2. the information contained in the report fairly presents, in all material respects, First Financial Northwest's financial condition and results of operations as of the dates and for the periods presented in the financial statements included in this report.

/s/Joseph W. Kiley III

Joseph W. Kiley III
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 8, 2019

/s/Richard P. Jacobson

Richard P. Jacobson Executive Vice President and Chief
Financial Officer
(Principal Financial Officer)

Date: November 8, 2019

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