First Financial Northwest, Inc.
Form 10-Q
November 09, 2012

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, 2012

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___

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes [X] No [ ]

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

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ] Smaller reporting company [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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 2, 2012, 18,805,168 shares of the issuer's common stock, $0.01 par value per share, were outstanding.

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Item 1. Financial Statements

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

Assets	September 30, 2012	December 31, 2011
Cash on hand and in banks	$5,265	$4,620
Interest-bearing deposits	103,968	160,141
Investments available-for-sale, at fair value	158,959	129,002
Loans receivable, net of allowance of $14,168 and $16,559	650,348	703,288
Premises and equipment, net	18,259	18,922
Federal Home Loan Bank stock, at cost	7,347	7,413
Accrued interest receivable	3,730	3,856
Federal income tax receivable	60	1,060
Deferred tax assets	1,000	-
Other real estate owned ("OREO")	19,209	26,044
Prepaid expenses and other assets	4,908	5,044
Total assets	$973,053	$1,059,390
Liabilities and Stockholders' Equity		
Interest-bearing deposits	$689,950	$782,652
Noninterest-bearing deposits	6,147	6,013
Advances from the Federal Home Loan Bank	83,066	83,066
Advance payments from borrowers for taxes and insurance	4,164	2,093
Accrued interest payable	187	184
Other liabilities	4,577	4,062
Total liabilities	788,091	878,070
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 18,805,168 shares at September 30, 2012 and December 31, 2011	188	188
Additional paid-in capital	190,085	188,816
Retained earnings, substantially restricted	5,139	3,937
Accumulated other comprehensive income, net of tax	835	511
Unearned Employee Stock Ownership Plan ("ESOP") shares	(11,285)	(12,132)
Total stockholders' equity	184,962	181,320
Total liabilities and stockholders' equity	$973,053	$1,059,390

See accompanying notes to consolidated financial statements.

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

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Interest income				
Loans, including fees	$9,539	$11,397	$29,813	$35,716
Investments available-for-sale	507	926	1,600	3,393
Interest-bearing deposits with banks	111	127	305	297
Total interest income	$10,157	$12,450	$31,718	$39,406
Interest expense				
Deposits	2,429	3,981	7,997	12,714
Federal Home Loan Bank advances	517	589	1,539	1,748
Total interest expense	$2,946	$4,570	$9,536	$14,462
Net interest income	7,211	7,880	22,182	24,944
Provision for loan losses	700	1,300	3,050	4,100
Net interest income after provision for loan losses	$6,511	$6,580	$19,132	$20,844
Noninterest income				
Net gain on sale of investments	-	479	288	1,741
Other	107	77	430	237
Total noninterest income	$107	$556	$718	$1,978
Noninterest expense				
Compensation and employee benefits	3,680	3,544	10,558	10,047
Occupancy and equipment	391	370	1,191	1,167
Professional fees	460	449	1,401	1,431
Data processing	174	181	540	573
Gain on sale of OREO property, net	(78)	(293)	(427)	(1,427)
OREO market value adjustments	1,157	515	1,702	1,432
OREO related expenses, net	486	540	1,421	2,376
Regulatory assessments	298	578	709	1,900
Insurance and bond premiums	100	248	300	743
Proxy contest and related litigation	264	-	868	-
Marketing	68	43	181	154
Other general and administrative	457	338	1,203	1,111
Total noninterest expense	$7,457	$6,513	$19,647	$19,507
Income (loss) before benefit for federal income taxes	(839)	623	203	3,315
Federal income tax benefit	(48)	-	(999)	-
Net income (loss)	$(791)	$623	$1,202	$3,315
Basic income (loss) per share	$(0.04)	$0.04	$0.07	$0.19
Diluted income (loss) per share	$(0.04)	$0.04	$0.07	$0.19

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income (Loss)
(In thousands)
(Unaudited)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income (loss)	$(791)	$623	$1,202	$3,315
Other comprehensive income (loss), before tax				
Unrealized holding gains on available-for-sale securities	815	402	612	2,060
Reclassification adjustment for net gains realized in income	-	(479)	(288)	(1,741)
Other comprehensive income (loss), before tax	815	(77)	324	319
Income tax benefit related to items of other comprehensive income (loss)	-	1,490	-	1,060
Other comprehensive income (loss), net of tax	$815	$(1,567)	$324	$(741)
Total comprehensive income (loss)	$24	$(944)	$1,526	$2,574

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Equity
For the Nine Months Ended September 30, 2012
(Dollars in thousands, except share data)
(Unaudited)

	Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income, Net of Tax	Unearned ESOP Shares	Total Stockholders' Equity
Balances at December 31, 2011	18,805,168	$188	$188,816	$3,937	$ 511	$(12,132)	$181,320
Total other comprehensive income, net of tax	-	-	-	1,202	324	-	1,526
Compensation related to stock options and restricted stock awards	-	-	1,472	-	-	-	1,472
Allocation of 84,640 ESOP shares	-	-	(203)	-	-	847	644
Balances at September 30, 2012	18,805,168	$188	$190,085	$5,139	$ 835	$(11,285)	$184,962

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

	Nine Months Ended September 30, 2012	2011
Cash flows from operating activities:		
Net income	$ 1,202	$ 3,315
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,050	4,100
OREO market value adjustments	1,702	1,432
Gain on sale of OREO property, net	(427)	(1,427)
Depreciation of premises and equipment	767	792
Net amortization of premiums and discounts on investments	1,260	1,835
ESOP expense	644	446
Compensation expense related to stock options and restricted stock awards	1,472	1,489
Net realized gain on investments available-for-sale	(288)	(1,741)
Loss from disposal of premises and equipment	9	-
Deferred federal income taxes	(1,000)	(1,061)
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	136	1,222
Federal income taxes, net	1,000	5,916
Accrued interest receivable	126	714
Accrued interest payable	3	14
Other liabilities	515	513
Investment transactions payable	-	10,000
Net cash provided by operating activities	$ 10,171	$ 27,559
Cash flows from investing activities:		
Proceeds from sales or calls of investments	23,200	74,633
Reimbursed (capitalized) improvements on OREO	16	(181)
Proceeds from sales of OREO properties	15,067	25,814
Principal repayments on investments	15,734	24,602
Purchases of investments	(69,539)	(74,679)
Net decrease in loans receivable	40,367	104,393
FHLB stock dividend redemption	66	-
Purchases of premises and equipment	(113)	(55)
Net cash provided by investing activities	$ 24,798	$ 154,527
Balance, carried forward	$ 34,969	$ 182,086

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

	Nine Months Ended September 30,			
	2012		2011	
Balance, brought forward	$	34,969	$	182,086
Cash flows from financing activities:				
Net decrease in deposits		(92,568)		(69,681)
Advances from the Federal Home Loan Bank		110		-
Repayments of advances from the Federal Home Loan Bank		(110)		-
Net increase in advance payments from borrowers for taxes and insurance		2,071		1,367
Net cash used by financing activities	$	(90,497)	$	(68,314)
Net increase (decrease) in cash		(55,528)		113,772
Cash and cash equivalents:				
Beginning of period		164,761		98,427
End of period	$	109,233	$	212,199
Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest	$	9,533	$	14,448
Federal income taxes	$	60	$	-
Noncash transactions:				
Loans, net of deferred loan fees and allowance for loan losses, transferred to OREO	$	9,523	$	20,737

See accompanying notes to consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 – Description of Business

First Financial Northwest, Inc. ("First Financial Northwest" or the "Company"), a Washington corporation, was formed on June 1, 2007 for the purpose of becoming the holding company for First Savings Bank Northwest ("First Savings Bank" or "the Bank") in connection with the conversion from a mutual holding company structure to a stock holding company structure. First Financial Northwest's business activities generally are limited to passive investment activities and oversight of its investment in First Savings Bank. Accordingly, the information presented in the consolidated financial statements and related data, relates primarily to First Savings Bank. First Financial Northwest is a savings and loan holding company and is subject to regulation by the Federal Reserve Board ("FRB"). First Savings Bank is regulated by the Federal Deposit Insurance Corporation ("FDIC") and the Washington State Department of Financial Institutions ("DFI").

First Savings Bank is a community-based savings bank primarily serving King, and to a lesser extent, Pierce, Snohomish and Kitsap counties through our full-service banking office located in Renton, Washington. First Savings Bank's business consists of attracting deposits from the public and utilizing these deposits to originate one-to-four family residential, multifamily, commercial real estate, business, consumer and construction/land development loans.

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

Note 2 – Regulatory Items

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

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

The MOU with the Bank contains provisions concerning the management and directors of the Bank, interest rate risk, minimum capital levels, the allowance for loan and lease losses ("ALLL"), lending and collection policies, policies concerning the Bank and its affiliates, restrictions on paying dividends and a requirement to furnish progress reports to the FDIC and DFI. A copy of the MOU with the Bank is attached to the Form 8-K that we filed with the Securities and Exchange Commission ("SEC") on April 2, 2012.

Note 3 – Basis of Presentation

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the 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 consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2011, as filed with the SEC. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of the 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 three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. 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 ALLL, the valuation of other real estate owned ("OREO") and the underlying collateral of loans in the process of foreclosure, deferred tax assets and the fair value of financial instruments.

Certain amounts in the unaudited consolidated financial statements for prior periods have been reclassified to conform to the current unaudited financial statement presentation.

Note 4 – Recently Issued Accounting Pronouncements

In April 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-03, Reconsideration of Effective Control for Repurchase Agreements. The ASU amends existing guidance to remove from the assessment of effective control, the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and, as well, the collateral maintenance implementation guidance related to that criterion. The provisions of ASU No. 2011-03 were effective for the Company's reporting period beginning on or after December 15, 2011. The ASU was applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date and early adoption was not permitted. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (International Financial Reporting Standards). The ASU amends existing guidance regarding the highest and best use and valuation premise by clarifying these concepts are only applicable to measuring the fair value of nonfinancial assets. The ASU also clarifies that the fair value measurement of financial assets and financial liabilities which have offsetting market risks or counterparty credit risks that are managed on a portfolio basis, when several criteria are met, can be measured at the net risk position. Additional disclosures about Level 3 fair value measurements are required including a quantitative disclosure of the unobservable inputs and assumptions used in the measurement, a description of the valuation process in place, and discussion of the sensitivity of fair value changes in unobservable inputs and interrelationships about those inputs as well as disclosure of the level of the fair value of items that are not measured at fair value in the financial statements but disclosure of fair value is required. The provisions of ASU No. 2011-04 were effective for the Company's reporting period beginning after December 15, 2011 and were applied prospectively. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. The ASU amends current guidance to allow a company the option of presenting the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The provisions do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments do not change the option for a company to present components of other comprehensive income either net of related tax effects or before related tax effects, with one amount shown for the aggregate income tax expense (benefit) related to the total of other comprehensive income items. The amendments do not affect how earnings per share is calculated or presented. The provisions of ASU No. 2011-05 were effective for the Company's reporting periods beginning after December 15, 2011 and were applied retrospectively. Early adoption was permitted and there were no required transition disclosures. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities. The ASU requires an entity to offset, and present as a single net amount, a recognized eligible asset and a recognized eligible liability when it has an unconditional and legally enforceable right of setoff and intends either

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. The ASU requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. This ASU is effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-12, Deferral of the Effective Date for Amendments to Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update 2011-05 ("ASU 2011-12"). This ASU defers only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. ASU 2011-12 was issued in order to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, the Company will continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before the issuance of ASU 2011-05. ASU 2011-12 was effective for the Company's financial statements for annual and interim periods beginning after December 31, 2011, and was applied prospectively. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-2, Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment ("ASU 2012-2"). This ASU states that an entity has the option to first assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount, in accordance with Codification Subtopic 350-30, Intangibles—Goodwill and Other, General Intangibles Other than Goodwill. Under guidance in this ASU, an entity also has the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. This ASU is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 5 – Investments

Investment securities available-for-sale are summarized as follows:

	September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$38,253	$1,341	$(1)	$39,593
Freddie Mac	16,439	376	-	16,815
Ginnie Mae	33,199	90	(124)	33,165
Municipal bonds	2,049	11	(233)	1,827
U.S. Government sponsored entities and agencies	67,395	191	(27)	67,559
Total	$157,335	$2,009	$(385)	$158,959

	December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Mortgage-backed investments:				
Fannie Mae	$50,981	$1,182	$-	$52,163
Freddie Mac	19,285	560	-	19,845
Ginnie Mae	7,416	79	-	7,495
Municipal bonds	2,085	32	(270)	1,847
U.S. Government sponsored entities and agencies	47,934	2	(284)	47,652
Total	$127,701	$1,855	$(554)	$129,002

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following table summarizes the aggregate fair value and gross unrealized loss by length of time those investments have been continuously in an unrealized loss position:

	September 30, 2012					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
Mortgage-backed investments:						
Fannie Mae	$4,892	$(1)	$-	$-	$4,892	$(1)
Ginnie Mae	16,358	(124)	-	-	16,358	(124)
Municipal bonds	-	-	1,173	(233)	1,173	(233)
U.S Government sponsored entities and agencies	12,883	(27)	-	-	12,883	(27)
Total	$34,133	$(152)	$1,173	$(233)	$35,306	$(385)

	December 31, 2011					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(In thousands)					
Municipal bonds	$-	$-	$1,137	$(270)	$1,137	$(270)
U.S. Government sponsored entities and agencies	45,039	(284)	-	-	45,039	(284)
Total	$45,039	$(284)	$1,137	$(270)	$46,176	$(554)

At September 30, 2012, we had one security with a gross unrealized loss of $233,000 with a fair value of $1.2 million that had an unrealized loss for greater than one year. At December 31, 2011, this same security had a gross unrealized loss of $270,000 with a fair value totaling $1.1 million that had an unrealized loss for greater than one year. We reviewed the financial condition of the entity underlying this security at both September 30, 2012 and December 31, 2011, and determined an other-than-temporary impairment ("OTTI") was not warranted.

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. We consider 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 OTTI are written down to fair value. For equity securities, the write-down is recorded as a realized loss in noninterest income on our Consolidated Statements of Operations. For debt securities, if we intend to sell the security or it is likely that we will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If we do not intend to sell the security and it is not likely that we will be required to sell the security but we do not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income ("OCI"). Impairment losses related to all other factors are presented as separate categories within OCI. For the three and nine months ended September 30, 2012 and 2011, we did not have any OTTI losses on investments.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The amortized cost and estimated fair value of investments available-for-sale at September 30, 2012, 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, 2012	
	Amortized Cost	Fair Value
	(In thousands)	
Due after one year through five years	$ 50,053	$ 50,078
Due after five years through ten years	4,722	4,760
Due after ten years	14,669	14,548
	69,444	69,386
Mortgage-backed investments	87,891	89,573
Total	$ 157,335	$ 158,959

Under Washington state law, in order to participate in the public funds program we are required to pledge as collateral an amount equal to 100% of the public deposits we hold in the form of eligible securities. Investments with a market value of $15.9 million and $31.8 million were pledged as collateral for public deposits at September 30, 2012 and December 31, 2011, respectively, both of which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission.

We did not sell any investments during the three months ended September 30, 2012. We sold $43.1 million of investments during the three months ended September 30, 2011, resulting in gross gains of $487,000. For the nine months ended September 30, 2012 and 2011, we sold $22.9 million and $72.9 million of investments, respectively, resulting in gross gains of $294,000 and $1.7 million, respectively.

There were no gross losses on the sales of investments for the three months ended September 30, 2012 and there were $8,000 of gross losses for the same period in 2011. For the nine months ended September 30, 2012 and 2011, there were gross losses on the sales of investments of $6,000 and $8,000, respectively.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 6 - Loans Receivable

Loans receivable are summarized as follows:

	September 30, 2012	December 31, 2011
	(In thousands)	
One-to-four family residential: (1)	$ 313,562	$ 335,412
Multifamily:		
Permanent	107,575	110,148
Construction	-	3,526
	107,575	113,674
Commercial real estate:		
Permanent	200,490	218,032
Construction	12,500	12,500
Land	1,947	1,811
	214,937	232,343
Construction/land development: (2)		
One-to-four family residential	1,625	6,194
Multifamily	806	855
Commercial	-	1,104
Land development	14,435	16,990
	16,866	25,143
Business	3,503	3,909
Consumer	10,778	12,499
Total loans	667,221	722,980
Less:		
Loans in process	931	1,372
Deferred loan fees, net	1,774	1,761
ALLL	14,168	16,559
Loans receivable, net	$ 650,348	$ 703,288

(1) Includes $144.5 million and $147.4 million of non-owner occupied loans at September 30, 2012 and December 31, 2011, respectively.

(2) Excludes construction loans that will convert to permanent loans. We consider these loans to be "rollovers" in that one loan is originated for both the construction loan and permanent financing. These loans are classified according to the underlying
collateral. As a result, at September 30, 2012, we had $12.5 million, or 5.8% of our total commercial real estate portfolio and no multifamily loans in these "rollover" type of

loans. At December 31, 2011, we had $12.5 milllion, or 5.4% of our total commercial real estate portfolio and $3.5 million, or 3.1% of our total multifamily loan portfolio in these "rollover" type of loans. At September 30, 2012 and December 31, 2011, $1.9 million and $1.8 million, respectively, of commercial real estate land loans were not included in the construction/land development category because we classify our buildable lots where we do not intend to finance the construction as commercial real estate land loans.

At September 30, 2012 and December 31, 2011, there were no loans classified as held for sale.

FIRST FINANCIAL NORTHWEST, INC. AND SUBSIDIARIES
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The following tables represent a summary of our ALLL and loan portfolio by loan type and impairment method:

	At or For the Three Months Ended September 30, 2012						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
ALLL:				(In thousands)			
Beginning balance	$5,966	$2,024	$5,634	$567	$35	$224	$14,450
Charge-offs	(681)	-	(1,313)	(149)	-	(198)	(2,341)
Recoveries	-	-	3	1,355	-	1	1,359
Provision	863	(707)	1,623	(1,275)	-	196	700
Ending balance	$6,148	$1,317	$5,947	$498	$35	$223	$14,168
General reserve	$4,831	$1,317	$5,741	$498	$35	$223	$12,645
Specific reserve	$1,317	$-	$206	$-	$-	$-	$1,523
Loans: (1)							
Total Loans	$313,562	$107,575	$214,937	$15,935	$3,503	$10,778	$666,290
General reserve (2)	$252,649	$101,621	$201,591	$7,938	$3,503	$10,637	$577,939
Specific reserve (3)	$60,913	$5,954	$13,346	$7,997	$-	$141	$88,351

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

	At or For the Nine Months Ended September 30, 2012						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
ALLL:	(In thousands)						
Beginning balance	$5,756	$950	$6,846	$2,503	$154	$350	$16,559
Charge-offs	(2,018)	(153)	(4,409)	(318)	-	(491)	(7,389)
Recoveries	12	-	475	1,457	-	4	1,948
Provision	2,398	520	3,035	(3,144)	(119)	360	3,050
Ending balance	$6,148	$1,317	$5,947	$498	$35	$223	$14,168
General reserve	$4,831	$1,317	$5,741	$498	$35	$223	$12,645
Specific reserve	$1,317	$-	$206	$-	$-	$-	$1,523
Loans: (1)							
Total Loans	$313,562	$107,575	$214,937	$15,935	$3,503	$10,778	$666,290
	$252,649	$101,621	$201,591	$7,938	$3,503	$10,637	$577,939

General reserve (2)							
Specific reserve (3)	$60,913	$5,954	$13,346	$7,997	$-	$141	$88,351

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

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	At or For the Three Months Ended September 30, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
ALLL:				(In thousands)			
Beginning balance	$5,499	$984	$7,279	$2,893	$14	$320	$16,989
Charge-offs	(371)	-	(590)	(633)	-	(92)	(1,686)
Recoveries	12	-	-	18	-	1	31
Provision	164	5	429	457	127	118	1,300
Ending balance	$5,304	$989	$7,118	$2,735	$141	$347	$16,634
General reserve	$4,739	$989	$7,074	$2,735	$141	$347	$16,025
Specific reserve	$565	$-	$44	$-	$-	$-	$609
Loans: (1)							
Total Loans	$346,222	$116,461	$236,775	$28,821	$3,531	$13,898	$745,708
General reserve (2)	$280,334	$113,311	$220,966	$16,930	$3,531	$13,784	$648,856
Specific reserve (3)	$65,888	$3,150	$15,809	$11,891	$-	$114	$96,852

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

	At or For the Nine Months Ended September 30, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total
ALLL:				(In thousands)			
Beginning balance	$8,302	$1,893	$6,742	$5,151	$7	$439	$22,534
Charge-offs	(1,987)	(88)	(4,184)	(3,815)	-	(263)	(10,337)
Recoveries	31	-	-	304	-	2	337
Provision	(1,042)	(816)	4,560	1,095	134	169	4,100
Ending balance	$5,304	$989	$7,118	$2,735	$141	$347	$16,634
General reserve	$4,739	$989	$7,074	$2,735	$141	$347	$16,025
Specific reserve	$565	$-	$44	$-	$-	$-	$609
Loans: (1)							
Total Loans	$346,222	$116,461	$236,775	$28,821	$3,531	$13,898	$745,708
General reserve (2)	$280,334	$113,311	$220,966	$16,930	$3,531	$13,784	$648,856
	$65,888	$3,150	$15,809	$11,891	$-	$114	$96,852

Specific reserve (3)	

(1) Net of undisbursed funds.
(2) Loans collectively evaluated for impairment.
(3) Loans individually evaluated for impairment.

Nonperforming loans, net of undisbursed funds, were $23.6 million and $23.7 million at September 30, 2012 and December 31, 2011, respectively. Foregone interest on nonaccrual loans for the three and nine months ended September 30, 2012 was $338,000 and $1.1 million, respectively. Foregone interest for the same periods in 2011 was $527,000 and $2.1 million, respectively.

There were no loans committed to be advanced in connection with impaired loans at September 30, 2012. At December 31, 2011, $36,000 was committed to be advanced in connection with impaired loans.

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Our loan portfolio is constantly being monitored for delinquent loans and changes in the financial condition of each borrower. When an issue is identified with one of our borrowers and it is determined that the loan needs to be classified as nonperforming and/or impaired, an evaluation of the collateral is performed prior to the end of the financial reporting period and, if necessary, an appraisal is ordered in accordance with our appraisal policy guidelines. Based on this evaluation, any additional provision for loan loss or charge-offs that may be needed is recorded prior to the end of the financial reporting period.

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 loan. When identifying loans as impaired, management takes into consideration factors which include payment history and status, collateral value, financial condition of the borrower and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered by management on a case-by-case basis, after taking into consideration the circumstances surrounding the loan and the borrower, including payment history and the amounts of any payment shortfall, length and reason for delay and the likelihood of a return to stable performance. Impairment is measured on a loan-by-loan basis for all loans in the portfolio. We obtain annual updated appraisals for impaired collateral dependent loans that exceed $1.0 million and loans that have been transferred to OREO. In addition, we may order appraisals on properties not included within these guidelines when there are extenuating circumstances where we are not otherwise able to determine the fair value of the property.

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

	September 30, 2012		
	Recorded Investment (1)	Unpaid Principal Balance (2)	Related Allowance
	(In thousands)		
Loans with no related allowance:			
One-to-four family residential:			
Owner occupied	$ 6,437	$ 7,538	$ -
Non-owner occupied	35,339	35,742	-
Multifamily	5,954	6,136	-
Commercial real estate	7,647	10,900	-
Construction/land development	7,997	12,671	-
Consumer	141	176	-
Total	63,515	73,163	-
Loans with an allowance:			
One-to-four family residential:			
Owner occupied	5,376	5,547	377
Non-owner occupied	13,761	13,965	940
Commercial real estate	5,699	5,699	206
Total	24,836	25,211	1,523
Total impaired loans:			
One-to-four family residential:			
Owner occupied	11,813	13,085	377
Non-owner occupied	49,100	49,707	940
Multifamily	5,954	6,136	-
Commercial real estate	13,346	16,599	206
Construction/land development	7,997	12,671	-
Consumer	141	176	-
Total	$ 88,351	$ 98,374	$ 1,523

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

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	December 31, 2011		
	Recorded Investment (1)	Unpaid Principal Balance (2)	Related Allowance
	(In thousands)		
Loans with no related allowance:			
One-to-four family residential:			
Owner occupied	$ 8,007	$ 8,931	$ -
Non-owner occupied	40,406	42,794	-
Multifamily	3,453	3,578	-
Commercial real estate	12,802	15,957	-
Construction/land development	9,199	22,776	-
Consumer	70	70	-
Total	73,937	94,106	-
Loans with an allowance:			
One-to-four family residential:			
Owner occupied	4,588	4,724	180
Non-owner occupied	9,575	9,735	325
Commercial real estate	1,817	1,817	59
Total	15,980	16,276	564
Total impaired loans:			
One-to-four family residential:			
Owner occupied	12,595	13,655	180
Non-owner occupied	49,981	52,529	325
Multifamily	3,453	3,578	-
Commercial real estate	14,619	17,774	59
Construction/land development	9,199	22,776	-
Consumer	70	70	-
Total	$ 89,917	$ 110,382	$ 564

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

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	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Average Recorded Investment (1)	Interest Income Recognized	Average Recorded Investment (1)	Interest Income Recognized
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$ 7,284	$ 46	$ 7,813	$ 119
Non-owner occupied	36,147	497	37,738	1,545
Multifamily	4,620	143	4,035	234
Commercial real estate	8,106	75	11,411	255
Construction/land development	8,364	-	8,729	-
Consumer	211	1	182	3
Total	64,732	762	69,908	2,156
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	4,814	56	4,617	185
Non-owner occupied	11,615	298	10,489	519
Commercial real estate	5,709	73	3,885	212
Total	22,138	427	18,991	916
Total impaired loans:				
One-to-four family residential:				
Owner occupied	12,098	102	12,430	304
Non-owner occupied	47,762	795	48,227	2,064
Multifamily	4,620	143	4,035	234
Commercial real estate	13,815	148	15,296	467
Construction/land development	8,364	-	8,729	-
Consumer	211	1	182	3
Total	$ 86,870	$ 1,189	$ 88,899	$ 3,072

(1) Represents the loan balance less charge-offs.

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(Unaudited)

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	Average Recorded Investment (1)	Interest Income Recognized	Average Recorded Investment (1)	Interest Income Recognized
	(In thousands)			
Loans with no related allowance:				
One-to-four family residential:				
Owner occupied	$ 7,618	$ 40	$ 7,747	$ 126
Non-owner occupied	44,759	552	44,858	1,683
Multifamily	3,154	42	2,833	126
Commercial real estate	13,311	112	11,744	329
Construction/land development	13,786	-	11,687	-
Consumer	114	1	123	2
Total	82,742	747	78,992	2,266
Loans with an allowance:				
One-to-four family residential:				
Owner occupied	5,207	57	5,216	193
Non-owner occupied	8,683	194	9,410	384
Multifamily	-	-	175	-
Commercial real estate	3,742	47	6,594	151
Construction/land development	-	-	9,332	-
Consumer	-	-	20	-
Total	17,632	298	30,747	728
Total impaired loans:				
One-to-four family residential:				
Owner occupied	12,825	97	12,963	319
Non-owner occupied	53,442	746	54,268	2,067
Multifamily	3,154	42	3,008	126
Commercial real estate	17,053	159	18,338	480
Construction/land development	13,786	-	21,019	-
Consumer	114	1	143	2
Total	$ 100,374	$ 1,045	$ 109,739	$ 2,994

(1) Represents the loan balance less charge-offs.

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We account for certain loan modifications or restructurings as troubled debt restructured loans ("TDRs"). In general, the modification or restructuring of a debt is considered a TDR if we, for economic or legal reasons related to the borrower's financial difficulties, grant a concession to the borrower that we would not otherwise consider. A loan that is determined to be classified as a TDR is generally reported as a TDR until the loan is paid in full or otherwise settled, sold or charged-off. The following is a summary of information pertaining to nonperforming assets and TDRs:

	September 30, 2012	December 31, 2011
	(In thousands)	
Nonperforming assets (1):		
Nonaccrual loans	$ 18,570	$ 18,613
Nonaccrual TDRs	5,013	5,079
Total nonaccrual loans	23,583	23,692
OREO	19,209	26,044
Total nonperforming assets	$ 42,792	$ 49,736
Performing TDRs	$ 64,768	$ 66,225
Nonaccrual TDRs	5,013	5,079
Total TDRs	$ 69,781	$ 71,304

(1) There were no loans 90 days or more past due and still accruing interest at September 30, 2012 and December 31, 2011.

The accrual status of a loan may change after it has been classified as a TDR. Once the loan is restructured, a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment are performed to assess the likelihood that all principal and interest payments required under the terms of the modified agreement will be collected in full.

Nonaccrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual when they are 90 days delinquent or when, in management's opinion, the borrower is unable to meet scheduled payment obligations.

In order to return a nonaccrual loan to accrual status, each loan is evaluated on a case-by-case basis. We evaluate the borrower's financial condition to ensure that future loan payments are reasonably assured. We also take into consideration the borrower's willingness and ability to make the loan payments and historical repayment performance. We require the borrower to make the loan payments consistently for a period of at least six months as agreed to under the terms of the modified loan agreement before we will consider reclassifying the loan to accrual status.

The following table is a summary of nonaccrual loans by loan type:

	September 30, 2012	December 31, 2011
	(In thousands)	
One-to-four family residential	$ 8,447	$ 9,808
Multifamily	4,711	949
Commercial real estate	2,287	3,736

Construction/land development		7,997		9,199
Consumer		141		-
Total nonaccrual loans	$	23,583	$	23,692

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The following tables represent a summary of the aging of loans by type:

	Loans Past Due at September 30, 2012					
	30-59 Days	60-89 Days	90 Days and Greater	Total	Current	Total Loans (1) (2)
			(In thousands)			
Real estate:						
One-to-four family residential:						
Owner occupied	$2,376	$672	$4,008	$7,056	$161,995	$169,051
Non-owner occupied	-	-	885	885	143,626	144,511
Multifamily	1,800	2,703	-	4,503	103,072	107,575
Commercial real estate	4,803	129	1,934	6,866	208,071	214,937
Construction/land development	166	-	4,015	4,181	11,754	15,935
Total real estate	9,145	3,504	10,842	23,491	628,518	652,009
Business	-	-	-	-	3,503	3,503
Consumer	345	644	119	1,108	9,670	10,778
Total	$9,490	$4,148	$10,961	$24,599	$641,691	$666,290

(1) There were no loans 90 days or more past due and still accruing interest at September 30, 2012.
(2) Net of undisbursed funds.

	Loans Past Due at December 31, 2011					
	30-59 Days	60-89 Days	90 Days and Greater	Total	Current	Total Loans (1) (2)
			(In thousands)			
Real estate:						
One-to-four family residential:						
Owner occupied	$2,594	$1,318	$4,076	$7,988	$180,009	$187,997
Non-owner occupied	761	-	3,224	3,985	143,394	147,379
Multifamily	-	-	949	949	112,314	113,263
Commercial real estate	633	-	2,621	3,254	228,583	231,837
Construction/land development	-	-	9,199	9,199	15,525	24,724
Total real estate	3,988	1,318	20,069	25,375	679,825	705,200
Business	240	-	-	240	3,669	3,909
Consumer	1,133	-	-	1,133	11,366	12,499
Total	$5,361	$1,318	$20,069	$26,748	$694,860	$721,608

(1) There were no loans 90 days or more past due and still accruing interest at December 31, 2011.
(2) Net of undisbursed funds.

Credit Quality Indicators. We utilize a nine-point risk rating system and assign a risk rating for all credit exposures. The risk rating system is designed to define the basic characteristics and identify risk elements of each credit extension. Credits risk rated 1 through 5 are considered to be "pass" credits. Pass credits can be assets where there is virtually no credit risk, such as cash secured loans with funds on deposit with the Bank. Pass credits also include credits that are on our 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. Credits classified as special mention are risk rated 6 and possess weaknesses that deserve management's close attention. Special mention assets do not expose the Bank to sufficient risk to warrant adverse classification in the substandard, doubtful or loss categories. Substandard credits are risk rated 7. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful are risk rated 8 and have all the weaknesses inherent in those credits classified as substandard with the added characteristic that the

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weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions and values. Assets classified as loss are risk rated 9 and are considered uncollectible and cannot be justified as a viable asset for the Bank.

The following tables represent a summary of loans by type and risk category:

	September 30, 2012						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (1)
	(In thousands)						
Risk Rating:							
Pass	$ 289,037	$ 101,621	$ 193,505	$ 7,772	$ 3,503	$ 9,778	$ 605,216
Special mention	12,283	-	13,277	166	-	644	26,370
Substandard	12,242	5,954	8,155	7,997	-	356	34,704
Total	$ 313,562	$ 107,575	$ 214,937	$ 15,935	$ 3,503	$ 10,778	$ 666,290

(1) Net of undisbursed funds.

	December 31, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (1)
	(In thousands)						
Risk Rating:							
Pass	$ 307,807	$ 106,900	$ 203,997	$ 15,101	$ 3,909	$ 11,822	$ 649,536
Special mention	13,193	5,414	14,256	424	-	488	33,775
Substandard	14,376	949	13,584	9,199	-	189	38,297
Total	$ 335,376	$ 113,263	$ 231,837	$ 24,724	$ 3,909	$ 12,499	$ 721,608

(1) Net of undisbursed funds.

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The following tables summarize the loan portfolio by type and payment activity:

	September 30, 2012						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (3)
	(In thousands)						
Performing (1)	$ 305,115	$ 102,864	$ 212,650	$ 7,938	$ 3,503	$ 10,637	$ 642,707
Nonperforming (2)	8,447	4,711	2,287	7,997	-	141	23,583
Total	$ 313,562	$ 107,575	$ 214,937	$ 15,935	$ 3,503	$ 10,778	$ 666,290

(1) There were $163.4 million of owner-occupied one-to-four family residential loans and $141.7 million of non-owner occupied one-to-four family residential loans classified as performing.
(2) There were $5.7 million of owner-occupied one-to-four family residential loans and $2.8 million of non-owner occupied one-to-four family residential loans classified as nonperforming.
(3) Net of undisbursed funds.

	December 31, 2011						
	One-to-Four Family Residential	Multifamily	Commercial Real Estate	Construction/ Land Development	Business	Consumer	Total (3)
	(In thousands)						
Performing (1)	$ 325,568	$ 112,314	$ 228,101	$ 15,525	$ 3,909	$ 12,499	$ 697,916
Nonperforming (2)	9,808	949	3,736	9,199	-	-	23,692
Total	$ 335,376	$ 113,263	$ 231,837	$ 24,724	$ 3,909	$ 12,499	$ 721,608

(1) There were $183.0 million of owner-occupied one-to-four family residential loans and $142.6 million of non-owner occupied one-to-four family residential loans classified as performing.
(2) There were $5.0 million of owner-occupied one-to-four family residential loans and $4.8 million of non-owner occupied one-to-four family residential loans classified as nonperforming.
(3) Net of undisbursed funds.

Management considers the following in determining the accrual status of restructured loans: (1) if the loan was on accrual status prior to the restructuring, the borrower has demonstrated performance under the previous terms, and our credit evaluation shows the borrower's capacity to continue to perform under the restructured terms (both principal and interest payments), the loan will remain on accrual at the time of the restructuring; (2) if the loan was on nonaccrual status before the restructuring, and our credit evaluation shows the borrower's capacity to meet the restructured terms, the loan would remain as nonaccrual for a minimum of six months until the borrower has demonstrated a reasonable period of sustained repayment performance (thereby providing reasonable assurance as to the ultimate collection of principal and interest in full under the modified terms).

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The following table presents TDRs and their recorded investment prior to the modification and after the modification:

	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	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)					
TDRs that Occurred During the Period:						
One-to-four family residential:						
Principal and interest with interest rate concession	21	$ 3,750	$ 3,738	22	$ 3,964	$ 3,950
Principal and interest reamortized no interest rate concession	1	71	71	1	71	71
Commercial real estate:						
Principal and interest with interest rate concession	-	-	-	1	1,415	1,400
Interest only payments with interest rate concession	-	-	-	2	2,508	2,504
Total	22	$ 3,821	$ 3,809	26	$ 7,958	$ 7,925

	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	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)					
TDRs that Occurred During the Period:						
One-to-four family residential:						
A/B note restructure	-	$ -	$ -	6	$ 1,130	$ 635
Interest only payments with interest rate concession	1	1,019	1,017	12	4,459	4,451
Principal and interest with interest rate concession	14	2,471	2,464	23	6,190	6,069
Interest only payments with no interest rate	-	-	-	2	527	510

concession						
Total	15	$ 3,490	$ 3,481	43	$ 12,306	$ 11,665

At September 30, 2012, the Company had no commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. All TDRs are classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the ALLL.

The TDRs that occurred during the three and nine months ended September 30, 2012 were primarily a result of granting the borrower interest rate concessions for a period of time ranging from one to three years. The impaired portion of the loan with an interest rate concession for a specific period of time is calculated based on the present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate is the rate of return implicit on the original loan. This impaired amount reduces the ALLL and a valuation allowance is established to reduce the loan balance. As loan payments are received in future periods, the ALLL entry is reversed and the valuation allowance is reduced utilizing the level yield method over the modification period. TDRs resulted in charge-offs to the ALLL of $107,000 for the three months ended September 30, 2012 and $751,000 for the nine months ended September 30, 2012.

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The following is a summary of loans that were modified as TDRs within the previous 12 months and for which there was a payment default during the three and nine months ended September 30, 2012 and 2011.

	Types of Modifications					
	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	Number of Loans	Interest Only Payments with Interest Rate Concession	Interest Rate Concession	Number of Loans	Interest Only Payments with Interest Rate Concession	Interest Rate Concession
	(Dollars in thousands)					
TDRs that Subsequently Defaulted:						
One-to-four family residential	2	$ 377	$ -	2	$ 377	$ -
Commercial real estate	1	495	-	2	1,895	-
Total	3	$ 872	$ -	4	$ 2,272	$ -

	Types of Modifications					
	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	Number of Loans	Interest Only Payments with Interest Rate Concession	Interest Rate Concession	Number of Loans	Interest Only Payments with Interest Rate Concession	Interest Rate Concession
	(Dollars in thousands)					
TDRs that Subsequently Defaulted:						
One-to-four family residential	3	$ -	$ 2,233	4	$ 391	$ 2,233

TDRs that default after they have been modified are typically evaluated individually on a collateral basis. Any additional impairment further reduces the ALLL.

Note 7 – Other Real Estate Owned

The following table is a summary of OREO:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Beginning balance	$22,206	$25,979	$26,044	$30,102
Loans transferred to OREO	1,501	4,787	9,523	20,737
Capitalized (reimbursed) improvements	(16)	91	(16)	181

Dispositions of OREO	(3,325)	(5,141)	(14,640)	(24,387)
Market value adjustments	(1,157)	(515)	(1,702)	(1,432)
Ending balance	$19,209	$25,201	$19,209	$25,201

OREO includes properties acquired by the Bank through foreclosure or deed in lieu of foreclosure. OREO at September 30, 2012 consisted of $5.1 million in one-to-four family residential homes, $560,000 in multifamily properties, $3.0 million in construction/land development projects and $10.6 million in commercial real estate properties.

Note 8 – Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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We determined the fair values of our 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 our estimates 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 our 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.

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The tables below present the balances of assets and liabilities measured at fair value on a recurring basis (there were no transfers between Level 1, Level 2 and Level 3 recurring measurements during the periods presented):

	Fair Value Measurements at September 30, 2012			
	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)			
Available-for-sale investments:				
Mortgage-backed investments:				
Fannie Mae	$39,593	$-	$39,593	$ -
Freddie Mac	16,815	-	16,815	-
Ginnie Mae	33,165	-	33,165	-
Municipal bonds	1,827	-	1,827	-
U.S. Government sponsored entities and agencies	67,559	-	67,559	-
Total	$158,959	$-	$158,959	$ -

	Fair Value Measurements at December 31, 2011			
	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)			
Available-for-sale investments:				
Mortgage-backed investments:				
Fannie Mae	$52,163	$-	$52,163	$ -
Freddie Mac	19,845	-	19,845	-
Ginnie Mae	7,495	-	7,495	-
Municipal bonds	1,847	-	1,847	-
U.S. Government sponsored entities and agencies	47,652	-	47,652	-
Total	$129,002	$-	$129,002	$ -

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.

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The tables below present the balances of assets and liabilities measured at fair value on a nonrecurring basis:

	Fair Value Measurements at September 30, 2012				
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses
			(In thousands)		
Impaired loans (included in loans receivable, net) (1) (2)	$ 86,828	$ -	$ -	$ 86,828	$ 1,523
OREO (3)	19,209	-	-	19,209	1,157
Total	$ 106,037	$ -	$ -	$ 106,037	$ 2,680

(1) The loss represents the specific reserve against loans that were considered impaired at September 30, 2012.
(2) There were no undisbursed funds at September 30, 2012.
(3) The loss represents OREO market value adjustments for the quarter ended September 30, 2012.

	Fair Value Measurements at December 31, 2011				
	Fair Value Measurements	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses
			(In thousands)		
Impaired loans including undisbursed but committed funds of $36 (included in loans receivable, net) (1)	$ 89,389	$ -	$ -	$ 89,389	$ 564
OREO (2)	26,044	-	-	26,044	1,924
Total	$ 115,433	$ -	$ -	$ 115,433	$ 2,488

(1) The loss represents the specific reserve against loans that were considered impaired at December 31, 2011.
(2) The loss represents OREO market value adjustments for the year ended December 31, 2011.

The fair value of impaired loans is calculated using the collateral value method or on a discounted cash flow basis. Inputs used in the collateral value method include appraised values, estimates of certain completion costs and closing and selling costs. Some of these inputs may not be observable in the marketplace. Appraised values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the borrower.

OREO properties are measured at the lower of their carrying amount or fair value, less 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 costs to sell, an impairment loss is recognized.

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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis.

	September 30, 2012			
	Fair Value (Dollars in thousands)	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans	$ 86,828	Market approach	Adjusted for differences between comparable sales	0% - 100% (1.4%)
OREO	$ 19,209	Market approach	Adjusted for differences between comparable sales	0% - 30% (13.0%)

The carrying amounts and estimated fair values of financial instruments were as follows:

	September 30, 2012				
	Carrying Value	Estimated Fair Value	Fair Value Measurements Using: Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash on hand and in banks	$ 5,265	$ 5,265	$ 5,265	$ -	$ -
Interest-bearing deposits	103,968	103,968	103,968	-	-
Investments available-for-sale	158,959	158,959	-	158,959	-
Loans receivable, net	650,348	681,776	-	-	681,776
Federal Home Loan Bank stock	7,347	7,347	7,347	-	-
Accrued interest receivable	3,730	3,730	-	3,730	-
Financial Liabilities:					
Deposits	195,233	195,233	195,233	-	-
Certificates of deposit	500,864	505,033	-	-	505,033
Advances from the FHLB	83,066	84,165	-	84,165	-
Accrued interest payable	187	187	-	187	-

	December 31, 2011	
	Carrying Value	Estimated Fair Value
	(In thousands)	
Financial Assets:		
Cash on hand and in banks	$ 4,620	$ 4,620
Interest-bearing deposits	160,141	160,141

Investments available-for-sale	129,002	129,002
Loans receivable, net	703,288	738,266
Federal Home Loan Bank stock	7,413	7,413
Accrued interest receivable	3,856	3,856
Financial Liabilities:		
Deposits	218,621	218,621
Certificates of deposit	570,044	577,570
Advances from the FHLB	83,066	84,926
Accrued interest payable	184	184

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Fair value estimates, methods, and assumptions are set forth below for our financial instruments.

- 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-bearing deposits, Federal Home Loan Bank of Seattle ("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: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans is estimated using discounted cash flow analysis, utilizing interest rates that would be offered for loans with similar terms to borrowers of similar credit quality. As a result of current market conditions, cash flow estimates have been further discounted to include a credit factor. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

- Liabilities: The fair value of deposits with no stated maturity, such as statement, NOW, 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.

Note 9 – Federal Home Loan Bank Stock

At September 30, 2012, we held $7.3 million of FHLB stock. FHLB stock is carried at par ($100 per share) and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par.

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

On October 25, 2010, the FHLB agreed to the stipulation and issuance of a Consent Order by its primary regulator, the Federal Housing Finance Agency ("FHFA"). The Consent Order sets forth requirements for capital

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management, asset composition, and other operational and risk management improvements. In addition, the FHLB may not repurchase member stock or pay dividends, until they achieve and maintain financial thresholds established by the FHFA as part of the agency's supervisory process, subject to FHFA approval. These restrictions are not expected to have a material effect on our financial position, liquidity or results of operation. We have determined there is no OTTI on the FHLB stock investment as of September 30, 2012.

During the third quarter of 2012, the FHLB announced that the FHFA had granted them the authority to repurchase up to $25 million in excess capital stock per quarter, provided that their financial condition – measured primarily by the ratio of market value of equity-to-par value of capital stock – does not deteriorate. As a result, the FHLB repurchased shares on a pro-rata basis from its shareholders, including 660 shares from the Bank, at par value during the third quarter of 2012.

Note 10 - Stock-Based Compensation

In June 2008, our shareholders approved the First Financial Northwest, Inc. 2008 Equity Incentive Plan ("Plan"). The Plan provides for the grant of stock options, restricted stock and stock appreciation rights.

Total compensation expense for the Plan was $539,000 and $540,000 for the three months ended September 30, 2012 and 2011, respectively, and the related income tax benefit was $189,000 for both quarters ended September 30, 2012 and 2011.

Total compensation expense for the Plan was $1.5 million for both nine month periods ended September 30, 2012 and 2011, and the related income tax benefit was $515,000 and $521,000 for the nine months ended September 30, 2012 and 2011, respectively.

Stock Options

The Plan authorizes the grant of stock options totaling 2,285,280 shares to our directors, advisory directors, officers and employees. Option awards are granted with an exercise price equal to the market price of our common stock at the grant date. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date and a contractual life of ten years. Any unexercised stock options will 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 or the Bank. We have a policy of issuing new shares from authorized but unissued common stock upon the exercise of stock options. At September 30, 2012, remaining options for –––886,756 shares of common stock were available for grant under the Plan.

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 our stock price over a specified period of time is used for the expected volatility assumption. We base the risk-free interest rate on the U.S. Treasury Constant Maturity Indices in effect on the date of the grant. We 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. There were 50,000 shares of options granted during both the three and nine months ended September 30, 2012. The fair value of options granted during the third quarter of 2012 was determined using the following assumptions as of the grant date:

Annual dividend yield	0.00%
Expected volatility	30.00%
Risk-free interest rate	1.06%
Expected term	6.5 years
Weighted-average grant date fair value per option granted	$2.58

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The following is a summary of our stock option plan awards for the nine months ended September 30, 2012:

	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, 2012	1,373,524	$ 9.52	6.60	$ 94	$ 1.91
Granted	50,000	8.01	9.97	2	2.58
Exercised	-	-	-		-
Forfeited or expired	(25,000)	9.78	-		1.92
Outstanding at September 30, 2012	1,398,524	9.46	6.00	203	1.93
Expected to vest assuming a 3% forfeiture rate over the vesting term	339,211	8.95	6.56	119	
Exercisable at September 30, 2012	1,048,819	9.63	5.81	80	

As of September 30, 2012, there was $537,000 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.6 years.

Restricted Stock Awards

The Plan authorizes the grant of restricted stock awards amounting to 914,112 shares to our directors, advisory directors, officers and employees. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the grant date. The restricted stock awards' fair value is equal to the value on the grant date. Shares awarded as restricted stock vest ratably over a five-year period beginning at the grant date with 20% vesting on the anniversary date of each grant date. At September 30, 2012, remaining restricted awards for 121,078 shares were available to be granted. Shares that have been repurchased totaled 212,847 and are held in trust until they are issued in connection with the agreement.

The following is a summary of changes in nonvested restricted stock awards for the nine months ended September 30, 2012:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2012	310,494	$ 9.66
Granted	50,000	8.01
Vested	(143,647)	9.93

Forfeited	(4,000)	10.35
Nonvested at September 30, 2012	212,847	9.08
Expected to vest assuming a 3% forfeiture rate over the vesting term	206,461	

As of September 30, 2012, there was $1.7 million 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 2.1 years. The total fair value of shares that vested during the quarters ended September 30, 2012 and 2011 was $1.3 million and $1.4 million, respectively. The total fair value of shares that vested during both nine month periods ended September 30, 2012 and 2011 was $1.4 million.

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Note 11 – Federal Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal income tax laws and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax assets and liabilities.

Our primary deferred tax assets relate to our ALLL, our contribution to the First Financial Northwest Foundation, our net operating loss carryforward and an impairment charge relating to a past investment in the AMF Ultra Short Mortgage Fund.

Under GAAP, a valuation allowance is required to be recognized if it is “more likely than not” that a portion of the deferred tax asset will not be realized. Our policy is to evaluate our deferred tax assets on a quarterly basis and record a valuation allowance for our deferred tax asset if we do not have sufficient positive evidence indicating that it is more likely than not that some or all of the deferred tax asset will be realized. Each quarter, we considered positive and negative evidence, which includes cumulative losses in the most recent three year period and uncertainty regarding short-term future earnings. We further considered that GAAP places heavy emphasis on prior earnings in determining the realizable deferred tax asset. After reviewing and weighing these various factors, in 2010 we recorded a valuation allowance for the balance of the deferred tax asset in excess of the tax carryback refund potential.

As of September 30, 2012, the consolidated balance sheet includes gross deferred tax assets of $26.4 million and a deferred tax asset valuation allowance of $22.1 million. Deferred tax assets that will most likely not be recognized total $5.3 million and relate to the contribution carryforward and the AMF capital loss carryforward. The remaining $21.1 million of tax assets may be recognized in the future if the Company remains profitable. Deferred tax liabilities totaled $3.3 million, resulting in a net deferred tax asset of $1.0 million at September 30, 2012.

Note 12 – 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. The inclusion of these awards in the computation of EPS was immaterial for the three and nine months ended September 30, 2012 and 2011. ESOP shares are considered outstanding for basic and diluted earnings per share when the shares are committed to be released.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands, except share data)			
Net income	$(791)	$623	$1,202	$3,315