

Edgar Filing: Sound Financial Bancorp, Inc. - Form 10-Q

Sound Financial Bancorp, Inc.  
Form 10-Q  
November 13, 2015

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

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FORM 10-Q

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

For the quarterly period ended September 30, 2015

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

COMMISSION FILE NUMBER 001-35633

Sound Financial Bancorp, Inc.  
(Exact Name of Registrant as Specified in its Charter)

Maryland 45-5188530  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

2005 5th Avenue, Suite 200, Seattle, Washington 98121  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (206) 448-0884

None

(Former name, former address and former fiscal year, if changed since last report)

Indicate by checkmark 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 NO

Indicate by checkmark whether the registrant has submitted electronically and posted on its corporate website, 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 NO

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

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

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Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES      NO

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

As of November 10, 2015, there were 2,465,907 shares of the registrant's common stock outstanding.

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SOUND FINANCIAL BANCORP, INC.  
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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Condensed Consolidated Balance Sheets

(In thousands, except share and per share amounts)

|  | September<br>30, 2015<br>(unaudited) | December<br>31, 2014<br>(unaudited) |
|--|--------------------------------------|-------------------------------------|
| <b>ASSETS</b>  |                                      |                                     |
| Cash and cash equivalents  | \$ 36,669                            | \$ 29,289                           |
| Available-for-sale securities, at fair value   | 7,140                                | 11,524                              |
| Loans held for sale  | 772                                  | 810                                 |
| Loans  | 435,829                              | 430,360                             |
| Allowance for loan losses  | (4,682 )                             | (4,387 )                            |
| Total Loans, net   | 431,147                              | 425,973                             |
| Accrued interest receivable  | 1,453                                | 1,497                               |
| Bank-owned life insurance (“BOLI”), net  | 11,661                               | 11,408                              |
| Other real estate owned (“OREO”) and repossessed assets, net   | 177                                  | 323                                 |
| Mortgage servicing rights, at fair value   | 3,226                                | 3,028                               |
| Federal Home Loan Bank (“FHLB”) stock, at cost   | 1,558                                | 2,224                               |
| Premises and equipment, net  | 5,580                                | 5,555                               |
| Other assets   | 2,638                                | 3,556                               |
| Total assets   | \$ 502,021                           | \$ 495,187                          |
| <b>LIABILITIES</b>   |                                      |                                     |
| Deposits   |                                      |                                     |
| Interest-bearing   | \$ 369,031                           | \$ 363,456                          |
| Noninterest-bearing demand   | 50,544                               | 44,353                              |
| Total deposits   | 419,575                              | 407,809                             |
| Borrowings   | 24,096                               | 30,578                              |
| Accrued interest payable   | 61                                   | 76                                  |
| Other liabilities  | 4,531                                | 5,606                               |
| Advance payments from borrowers for taxes and insurance  | 895                                  | 474                                 |
| Total liabilities  | 449,158                              | 444,543                             |
| <b>COMMITMENTS AND CONTINGENCIES (NOTE 7)</b>  |                                      |                                     |
|  | -                                    | -                                   |
| <b>STOCKHOLDERS' EQUITY</b>  |                                      |                                     |
| Preferred stock, \$0.01 par value, 1,000,000 shares authorized, none issued or outstanding   | -                                    | -                                   |
| Common stock, \$0.01 par value, 40,000,000 shares authorized, 2,465,907 and 2,524,645 shares issued and outstanding as of September 30, 2015 and December 31, 2014, respectively | 25                                   | 25                                  |
| Additional paid-in capital   | 22,643                               | 23,552                              |
| Unearned shares - Employee Stock Ownership Plan (“ESOP”)   | (1,140 )                             | (1,140 )                            |
| Retained earnings  | 31,168                               | 28,024                              |
| Accumulated other comprehensive income (loss), net of tax  | 167                                  | 183                                 |
| Total stockholders' equity   | 52,863                               | 50,644                              |
| Total liabilities and stockholders' equity   | \$ 502,021                           | \$ 495,187                          |

See notes to condensed consolidated financial statements

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Condensed Consolidated Statements of Income (unaudited)

(In thousands, except per share amounts)

|  | Three Months<br>Ended<br>September 30, |         | Nine Months<br>Ended<br>September 30, |          |
|--|--|---------|---------------------------------------|----------|
|  | 2015                                   | 2014    | 2015                                  | 2014     |
| <b>INTEREST INCOME</b>   |  |         |                                       |          |
| Loans, including fees  | \$5,537                                | \$5,339 | \$16,222                              | \$15,687 |
| Interest and dividends on investments, cash and cash equivalents | 39                                     | 56      | 141                                   | 151      |
| Total interest income  | 5,576                                  | 5,395   | 16,363                                | 15,838   |
| <b>INTEREST EXPENSE</b>  |  |         |                                       |          |
| Deposits   | 662                                    | 580     | 1,985                                 | 1,692    |
| Borrowings   | 23                                     | 32      | 70                                    | 126      |
| Total interest expense   | 685                                    | 612     | 2,055                                 | 1,818    |
| Net interest income  | 4,891                                  | 4,783   | 14,308                                | 14,020   |
| <b>PROVISION FOR LOAN LOSSES</b>                                 |  |         |                                       |          |
| Net interest income after provision for loan losses              | 4,791                                  | 4,583   | 13,908                                | 13,420   |
| <b>NONINTEREST INCOME</b>  |  |         |                                       |          |
| Service charges and fee income                                   | 641                                    | 805     | 1,958                                 | 2,040    |
| Earnings on cash surrender value of bank-owned life insurance    | 85                                     | 87      | 253                                   | 253      |
| Mortgage servicing income  | 202                                    | 202     | 671                                   | 235      |
| Fair value adjustment on mortgage servicing rights               | (22 )                                  | 153     | 147                                   | 437      |
| Loss on sale of securities                                       | -                                      | -       | (31 )                                 | -        |
| Net gain on sale of loans  | 360                                    | 184     | 1,146                                 | 371      |
| Total noninterest income   | 1,266                                  | 1,431   | 4,144                                 | 3,336    |
| <b>NONINTEREST EXPENSE</b>                                       |  |         |                                       |          |
| Salaries and benefits  | 2,251                                  | 1,998   | 6,711                                 | 6,023    |
| Operations   | 1,064                                  | 1,155   | 3,021                                 | 3,056    |
| Regulatory assessments   | 180                                    | 66      | 476                                   | 201      |
| Occupancy  | 413                                    | 381     | 1,186                                 | 994      |
| Data processing  | 378                                    | 606     | 1,233                                 | 1,278    |
| Net loss (gain) on sale of OREO and repossessed assets           | 96                                     | (12 )   | 178                                   | 149      |
| Total noninterest expense  | 4,382                                  | 4,194   | 12,805                                | 11,701   |
| Income before provision for income taxes                         | 1,675                                  | 1,820   | 5,247                                 | 5,055    |
| Provision for income taxes                                       | 560                                    | 585     | 1,677                                 | 1,617    |
| Net income   | \$1,115                                | \$1,235 | \$3,570                               | \$3,438  |
| Earnings per common share:                                       |  |         |                                       |          |
| Basic  | \$0.45                                 | \$0.49  | \$1.43                                | \$1.37   |
| Diluted  | \$0.44                                 | \$0.47  | \$1.38                                | \$1.32   |
| Weighted average number of common shares outstanding:            |  |         |                                       |          |
| Basic  | 2,465                                  | 2,516   | 2,500                                 | 2,511    |
| Diluted  | 2,552                                  | 2,609   | 2,586                                 | 2,605    |

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(In thousands)

|  | Three Months<br>Ended<br>September 30, |         | Nine Months<br>Ended<br>September 30, |         |
|--|--|---------|---------------------------------------|---------|
|  | 2015                                   | 2014    | 2015                                  | 2014    |
| Net income   | \$1,115                                | \$1,235 | \$3,570                               | \$3,438 |
| Available for sale securities:   |  |         |                                       |         |
| Unrealized gains (losses) arising during the period, net of tax provision (benefits) of \$(10), \$33, \$(19) and \$234, respectively | (19 )                                  | 64      | (36 )                                 | 456     |
| Reclassification adjustment for net losses realized in income, net of tax provision of \$0, \$0, \$11, and \$0, respectively.        | -                                      | -       | 20                                    | -       |
| Other comprehensive income, net of tax   | (19 )                                  | 64      | (16 )                                 | 456     |
| Comprehensive income   | \$1,096                                | \$1,299 | \$3,554                               | \$3,894 |

See notes to condensed consolidated financial statements

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Condensed Consolidated Statements of Stockholders' Equity

For the Nine Months Ended September 30, 2015 and 2014 (unaudited)

(Dollars in thousands, except per share amounts)

|  | Shares    | Common<br>Stock | Additional<br>Paid-<br>in Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss, net of<br>tax | Total<br>Stockholders'<br>Equity |
|--|-----------|-----------------|-----------------------------------|----------------------------|----------------------|--|----------------------------------|
| Balances at December 31, 2013                        | 2,510,810 | \$ 25           | \$ 23,829                         | \$ (1,369 )                | \$ 24,288            | \$ (269 )  | \$ 46,504                        |
| Net income   |           |                 |                                   |                            | 3,438                |  | 3,438                            |
| Other comprehensive income, net<br>of tax            |           |                 |                                   |                            |                      | 456  | 456                              |
| Share-based compensation                             |           |                 | 289                               |                            |                      |  | 289                              |
| Cash dividends on common stock<br>(\$0.05 per share) |           |                 |                                   |                            | (378 )               |  | (378 )                           |
| Restricted stock awards issued                       | 45,565    |                 |                                   |                            |                      |  |                                  |
| Common stock repurchased                             | (53,340 ) |                 | (904 )                            |                            |                      |  | (904 )                           |
| Exercise of options                                  | 13,360    |                 | 4                                 |                            |                      |  | 4                                |
| Balances at September 30, 2014                       | 2,516,395 | \$ 25           | \$ 23,218                         | \$ (1,369 )                | \$ 27,348            | \$ 187   | \$ 49,409                        |

|   | Shares    | Common<br>Stock | Additional<br>Paid-<br>in Capital | Unearned<br>ESOP<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>income, net of<br>tax | Total<br>Stockholders'<br>Equity |
|---|-----------|-----------------|-----------------------------------|----------------------------|----------------------|--|----------------------------------|
| Balances at December 31, 2014                             | 2,524,645 | \$ 25           | \$ 23,552                         | \$ (1,140 )                | \$ 28,024            | \$ 183   | \$ 50,644                        |
| Net income  |           |                 |                                   |                            | 3,570                |  | 3,570                            |
| Other comprehensive income, net of<br>tax                 |           |                 |                                   |                            |                      | (16 )  | (16 )                            |
| Share-based compensation                                  |           |                 | 322                               |                            |                      |  | 322                              |
| Cash dividends paid on common<br>stock (\$0.17 per share) |           |                 |                                   |                            | (426 )               |  | (426 )                           |
| Restricted stock awards issued                            | 10,208    |                 |                                   |                            |                      |  |                                  |
| Restricted stock forfeited and<br>retired                 | (8,981 )  |                 |                                   |                            |                      |  |                                  |
| Common stock repurchased                                  | (63,371 ) |                 | (1,261 )                          |                            |                      |  | (1,261 )                         |
| Exercise of options                                       | 3,406     |                 | 30                                |                            |                      | -  | 30                               |
| Balances at September 30, 2015                            | 2,465,907 | \$ 25           | \$ 22,643                         | \$ (1,140 )                | \$ 31,168            | \$ 167   | \$ 52,863                        |

See notes to condensed consolidated financial statements



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Condensed Consolidated Statements of Cash Flows (unaudited)  
(In thousands)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2015                               | 2014      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                                    |           |
| Net income  | \$3,570                            | \$3,438   |
| Adjustments to reconcile net income to net cash from operating activities               |                                    |           |
| Accretion of net premium on investments   | 96                                 | 329       |
| Loss on sale of securities  | 31                                 | -         |
| Provision for loan losses   | 400                                | 600       |
| Depreciation and amortization   | 515                                | 407       |
| Compensation expense related to stock options and restricted stock                      | 322                                | 289       |
| Fair value adjustment on mortgage servicing rights                                      | (147 )                             | (437 )    |
| Additions to mortgage servicing rights  | (582 )                             | (341 )    |
| Amortization of mortgage servicing rights   | 531                                | 647       |
| Increase in cash surrender value of BOLI  | (253 )                             | (253 )    |
| Gain on sale of loans   | (1,146 )                           | (371 )    |
| Proceeds from sale of loans   | 60,280                             | 33,897    |
| Originations of loans held for sale   | (59,096)                           | (35,886 ) |
| Net Loss on sale and write-downs of OREO and repossessed assets                         | 95                                 | 16        |
| Change in operating assets and liabilities  |                                    |           |
| Accrued interest receivable   | 44                                 | (80 )     |
| Other assets  | 926                                | (170 )    |
| Accrued interest payable  | (15 )                              | (10 )     |
| Other liabilities   | (1,075 )                           | 431       |
| Net cash from (used by) operating activities  | 4,496                              | 2,506     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                    |           |
| Proceeds from principal payments, maturities and sales of available for sale securities | 4,233                              | 2,838     |
| FHLB stock redeemed   | 666                                | 67        |
| Net increase in loans   | (6,024 )                           | (26,329 ) |
| Improvements to OREO and other repossessed assets                                       | -                                  | (11 )     |
| Proceeds from sale of OREO and other repossessed assets                                 | 501                                | 1,367     |
| Purchases of premises and equipment, net  | (540 )                             | (218 )    |
| Net cash used by investing activities   | (1,164 )                           | (22,286 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                                    |           |
| Net increase in deposits  | 11,766                             | 33,232    |
| Net cash received from acquisition  | -                                  | 16,698    |
| Proceeds from borrowings  | 64,000                             | 135,500   |
| Repayment of borrowings   | (70,482)                           | (157,983) |
| Dividends paid on common stock  | (426 )                             | (378 )    |
| Net change in advances from borrowers for taxes and insurance                           | 421                                | 416       |
| Proceeds from stock option exercises  | 30                                 | 4         |
| Repurchase of common stock  | (1,261 )                           | (904 )    |
| Net cash from financing activities  | 4,048                              | 26,585    |
| Net increase in cash and cash equivalents   | 7,380                              | 6,805     |
| Cash and cash equivalents, beginning of period  | 29,289                             | 15,334    |
| Cash and cash equivalents, end of period  | 36,669                             | \$22,139  |

SUPPLEMENTAL CASH FLOW INFORMATION:

|  |         |             |
|--|---------|-------------|
| Cash paid for income taxes   | \$2,325 | \$1,275     |
| Interest paid on deposits and borrowings                                     | \$2,070 | \$1,828     |
| Noncash net transfer from loans to OREO and repossessed assets               | \$450   | \$453       |
| The following summarizes the non-cash activities related to the acquisition: |         |             |
| Fair value of assets acquired  | \$-     | \$4,904     |
| Fair value of liabilities assumed  | \$-     | \$(21,602 ) |
| Net fair value of liabilities  | \$-     | \$(16,698 ) |

See notes to condensed consolidated financial statements

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 – Basis of Presentation

The accompanying financial information is unaudited and has been prepared from the consolidated financial statements of Sound Financial Bancorp, Inc., and its wholly owned subsidiary, Sound Community Bank. References in this document to Sound Financial Bancorp refer to Sound Financial Bancorp, Inc. and its predecessor, Sound Financial, Inc., a federal corporation, and references to the “Bank” refer to Sound Community Bank. References to “we,” “us,” and “our” or the “Company” means Sound Financial Bancorp and its wholly-owned subsidiary, Sound Community Bank unless the context otherwise requires.

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. These unaudited financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2014, as filed with the SEC on March 31, 2015 (“2014 Form 10-K”). The results for the interim periods are not necessarily indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2014, included in the 2014 Form 10-K. Certain amounts in the prior quarters’ consolidated financial statements have been reclassified to conform to the current presentation. These classifications do not have an impact on previously reported consolidated net income, retained earnings, stockholders’ equity or earnings per share.

Note 2 – Accounting Pronouncements Recently Issued or Adopted

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

In February 2015, the FASB issued ASU No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis, which is intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). The ASU focuses on simplifying the consolidation evaluation for reporting organizations that are required to evaluate whether they should consolidate certain legal entities by reducing the number of consolidation model from four to two, among other changes. The ASU will be effective for periods beginning after December 31, 2015, while early adoption is permitted. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The amendments in this ASU require that debt issuance costs related to a

recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected. ASU No 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. ASU No. 2015-03 should be applied on a retrospective basis. The Company is currently evaluating the impacts of this ASU on the Company's consolidated financial statements.

In April 2015, FASB issued ASU No. 2015-05, Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. The amendments in this ASU provide guidance to customers in cloud computing arrangements about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments are effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. This ASU is not expected to have a material effect on the Company's consolidated financial statements.

In June 2015, FASB issued ASU No. 2015-10, Technical Corrections and Improvements. On November 10, 2010 FASB added a standing project that will facilitate the FASB Accounting Standards Codification ("Codification") updates for technical corrections, clarifications, and improvements. These amendments are referred to as Technical Corrections and Improvements. Maintenance updates include non-substantive corrections to the Codification, such as editorial corrections, various link-related changes, and changes to source fragment information. This update contains amendments that will affect a wide variety of Topics in the Codification. The amendments in this ASU will apply to all reporting entities within the scope of the affected accounting guidance and generally fall into one of four categories: amendments related to differences between original guidance and the Codification, guidance clarification and reference corrections, simplification, and minor improvements. In summary, the amendments in this ASU represent changes to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice. Transition guidance varies based on the amendments in this ASU. The amendments in this ASU that require transition guidance are effective for fiscal years and interim reporting periods after December 15, 2015. Early adoption is permitted including adoption in an interim period. All other amendments are effective upon the issuance of this ASU. ASU 2015-10 did not have a material impact on the Company's consolidated financial statements.

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In July 2015, the FASB issued ASU 2015-12, "Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): (Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient (consensuses of the FASB Emerging Issues Task Force)." The amendments of this ASU (i) require fully benefit-responsive investment contracts to be measured, presented and disclosed only at contract value, not fair value; (ii) simplify the investment disclosure requirements; and (iii) provide a measurement date practical expedient for employee benefit plans. This ASU is effective for fiscal years beginning after December 15, 2015, earlier adoption application is permitted. This ASU is not expected to have a material effect on the Company's consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers, deferring the effective date of the new revenue standard by one year. The standard also allows entities to choose to adopt the standard as of the original effective date. The FASB decided, based on its outreach to various stakeholders and the forthcoming amendments to the new revenue standard, that a deferral is necessary to provide adequate time to effectively implement the new revenue standard.

In August 2015, the FASB issued ASU No. 2015-15, Interest—Imputation of Interest (Subtopic 835-30), Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements. The ASU provides guidance not previously included in ASU 2015-03 regarding debt issuance related to line-of-credit arrangements. The amendment allows an entity to present debt issuance costs as an asset and subsequently amortize the deferred debt issuance costs over the term of the line-of-credit arrangement, regardless if there are any outstanding borrowings on the line-of-credit arrangement. The amendment is effective for fiscal years beginning after December 15, 2015. This ASU is not expected to have a material effect on the Company's consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805). The ASU simplifies the accounting for measurement period adjustments. The amendments require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period when the adjustment amounts are determined. The acquirer is required to record in the same period's financial statements the effect on earnings from changes in depreciation, amortization, or other income effects resulting from the change to provisional amounts, calculated as if the accounting had been completed at the acquisition date. The acquirer must present separately on the income statement, or disclose in the notes, the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the provisional amount had been recognized at the acquisition date. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. This ASU is not expected to have a material effect on the Company's consolidated financial statements.

## Note 3 – Investments

The amortized cost and fair value of our available-for-sale ("AFS") securities and the corresponding amounts of gross unrealized gains and losses at the dates indicated were as follows (in thousands):

|                                       | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
| September 30, 2015                    |                   |                              |                               |                            |
| Municipal bonds                       | \$ 1,912          | \$ 152                       | \$ -                          | \$ 2,064                   |
| Agency mortgage-backed securities     | 4,510             | 111                          | (13 )                         | 4,608                      |
| Non-agency mortgage-backed securities | 492               | -                            | (24 )                         | 468                        |
| Total                                 | \$ 6,914          | \$ 263                       | \$ (37 )                      | \$ 7,140                   |
| December 31, 2014                     |                   |                              |                               |                            |

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|                                       |           |        |          |           |
|---------------------------------------|-----------|--------|----------|-----------|
| Municipal bonds                       | \$ 1,911  | \$ 172 | \$ -     | \$ 2,083  |
| Agency mortgage-backed securities     | 7,024     | 110    | (38 )    | 7,096     |
| Non-agency mortgage-backed securities | 2,312     | 83     | (50 )    | 2,345     |
| Total                                 | \$ 11,247 | \$ 365 | \$ (88 ) | \$ 11,524 |

The amortized cost and fair value of AFS securities at September 30, 2015, by contractual maturity, are shown below (in thousands). Expected maturities of AFS securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                   | At September<br>30, 2015 |               |
|-----------------------------------|--------------------------|---------------|
|                                   | Amortized<br>Cost        | Fair<br>Value |
| Due after five years to ten years | 260                      | 276           |
| Due after ten years               | 6,654                    | 6,864         |
| Total                             | \$6,914                  | \$7,140       |

No securities were pledged to secure Washington State Public Funds as of September 30, 2015.

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There were no sales of AFS securities during the three months ended September 30, 2015. We sold \$1.7 million of non-agency mortgage-backed securities generating gross losses of \$31,000 and no gross gains during the nine months ended September 30, 2015. There were no sales of AFS securities during the three or nine months ended September 30, 2014.

The following tables summarize at the dates indicated the aggregate fair value and gross unrealized loss by length of time of those investments that have been continuously in an unrealized loss position (in thousands):

|                                       | September 30, 2015     |                    |                        |                    |               |                    |
|---------------------------------------|------------------------|--------------------|------------------------|--------------------|---------------|--------------------|
|                                       | Less Than 12<br>Months |                    | 12 Months or<br>Longer |                    | Total         |                    |
|                                       | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| Agency mortgage-backed securities     | \$-                    | \$ -               | \$1,419                | \$ (13 )           | \$1,419       | \$ (13 )           |
| Non-agency mortgage-backed securities | -                      | -                  | 468                    | (24 )              | 468           | (24 )              |
| Total                                 | \$-                    | \$ -               | \$1,887                | \$ (37 )           | \$1,887       | \$ (37 )           |

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

|                                       | December 31, 2014      |                    |                        |                    |               |                    |
|---------------------------------------|------------------------|--------------------|------------------------|--------------------|---------------|--------------------|
|                                       | Less Than 12<br>Months |                    | 12 Months or<br>Longer |                    | Total         |                    |
|                                       | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| Agency mortgage-backed securities     | \$627                  | \$ (6 )            | \$2,216                | \$ (32 )           | \$2,843       | \$ (38 )           |
| Non-agency mortgage-backed securities | -                      | -                  | 507                    | (50 )              | 507           | (50 )              |
| Total                                 | \$627                  | \$ (6 )            | \$2,723                | \$ (82 )           | \$3,350       | \$ (88 )           |

The following table presents the cumulative roll forward of credit losses recognized in earnings during the three and nine months ended September 30, 2015 and 2014 relating to the Company's non-U.S. agency mortgage-backed securities (in thousands):

|   | Three<br>Months<br>Ended<br>September<br>30, |        | Nine Months<br>Ended<br>September<br>30, |        |
|---|--|--------|--|--------|
|   | 2015   | 2014   | 2015                                     | 2014   |
| Estimated credit losses, beginning balance            | \$ -   | \$ 450 | \$ 450                                   | \$ 450 |
| Additions for credit losses not previously recognized | -  | -      | -  | -      |
| Reduction for increases in cash flows                 | -  | -      | -  | -      |
| Reduction of related OTTI due to sales                | -  | -      | (450)                                    | -      |
| Reduction for realized losses                         | -  | -      | -  | -      |
| Estimated credit losses, ending balance               | \$ -   | \$ 450 | \$ -                                     | \$ 450 |

At September 30, 2015, our securities portfolio consisted of 13 agency mortgage-backed securities, one non-agency mortgage-backed security and five municipal bonds with a fair value of \$7.1 million. At December 31, 2014, our securities portfolio consisted of 15 agency mortgage-backed securities, five non-agency mortgage-backed securities and five municipal bonds with an aggregate fair value of \$11.5 million. At September 30, 2015, the only non-agency mortgage-backed security was in an unrealized loss position compared to three of the 15 agency mortgage-backed securities at December 31, 2014. All of the agency mortgage-backed securities in an unrealized loss position at September 30, 2015 and December 31, 2014 were issued or guaranteed by U.S. governmental agencies. The unrealized losses were caused by changes in market interest rates or the widening of market spreads subsequent to the initial purchase of these securities, and not related to the underlying credit of the issuers or the underlying collateral. It is expected that these securities will not be settled at a price less than the amortized cost of each investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because we do not intend to sell the securities in this class and it is not likely that we will be required to sell these securities before recovery of their amortized cost basis, which may include holding each security until contractual maturity, the unrealized losses on these investments are not considered an other-than-temporary impairment ("OTTI").

As of September 30, 2015, the only non-agency mortgage-backed security in our portfolio was in an unrealized loss position compared to one of the five non-agency mortgage-backed securities contained in our portfolio at December 31, 2014. The unrealized loss was caused by changes in interest rates and market illiquidity causing a decline in the fair value subsequent to the purchase. The contractual term of this investment does not permit the issuer to settle the security at a price less than par. Because the decline in fair value is attributable to changes in interest rates or



widening market spreads and not credit quality, and because we do not intend to sell the security and it is not likely that we will be required to sell this security before recovery of its amortized cost basis, which may include holding the security until contractual maturity, the unrealized loss on this investment is not considered an OTTI.

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Notes to Condensed Consolidated Financial Statements (unaudited)

## Note 4 – Loans

The composition of the loan portfolio at the dates indicated, excluding loans held for sale, was as follows (in thousands):

|                            | At<br>September<br>30,<br>2015 | At<br>December<br>31,<br>2014 |
|----------------------------|--------------------------------|-------------------------------|
| Real estate loans:         |                                |                               |
| One- to four- family       | \$ 137,131                     | \$ 133,031                    |
| Home equity                | 31,821                         | 34,675                        |
| Commercial and multifamily | 164,179                        | 168,952                       |
| Construction and land      | 49,034                         | 46,279                        |
| Total real estate loans    | \$ 382,165                     | 382,937                       |
| Consumer loans:            |                                |                               |
| Manufactured homes         | 13,632                         | 12,539                        |
| Other consumer             | 20,987                         | 16,875                        |
| Total consumer loans       | 34,619                         | 29,414                        |
| Commercial business loans  | 20,674                         | 19,525                        |
| Total loans                | 437,458                        | 431,876                       |
| Deferred fees              | (1,629 )                       | (1,516 )                      |
| Total loans, gross         | 435,829                        | 430,360                       |
| Allowance for loan losses  | (4,682 )                       | (4,387 )                      |
| Total loans, net           | \$ 431,147                     | \$ 425,973                    |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2015 (in thousands):

|   | One- to<br>four-<br>family | Home<br>equity | Commercial<br>and<br>multifamily | Construction<br>and land | Manufactured<br>homes | Other<br>consumer | Commercial<br>business | Unallocated | Total    |
|---|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-------------|----------|
| Allowance for<br>loan losses:               |                            |                |                                  |                          |                       |                   |                        |             |          |
| Individually<br>evaluated for<br>impairment | \$ 661                     | \$ 89          | \$ 183                           | \$ 18                    | \$ 60                 | \$ -              | \$ 11                  | \$ -        | \$ 1,022 |
| Collectively<br>evaluated for<br>impairment | 1,107                      | 430            | 1,158                            | 99                       | 132                   | 169               | 123                    | 442         | 3,660    |
| Ending balance                              | \$ 1,768                   | \$ 519         | \$ 1,341                         | \$ 117                   | \$ 192                | \$ 169            | \$ 134                 | \$ 442      | \$ 4,682 |
| Loans<br>receivable:                        |                            |                |                                  |                          |                       |                   |                        |             |          |
| Individually<br>evaluated for<br>impairment | \$ 5,984                   | \$ 913         | \$ 1,976                         | \$ 134                   | \$ 362                | \$ 81             | \$ 157                 | \$ -        | \$ 9,607 |
|   | 131,147                    | 30,908         | 162,203                          | 48,900                   | 13,270                | 20,906            | 20,517                 | -           | 427,851  |

Collectively  
evaluated for  
impairment

|                |            |           |            |           |           |           |           |      |            |
|----------------|------------|-----------|------------|-----------|-----------|-----------|-----------|------|------------|
| Ending balance | \$ 137,131 | \$ 31,821 | \$ 164,179 | \$ 49,034 | \$ 13,632 | \$ 20,987 | \$ 20,674 | \$ - | \$ 437,458 |
|----------------|------------|-----------|------------|-----------|-----------|-----------|-----------|------|------------|

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2014 (in thousands):

|                                       | One-to-four family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Unallocated | Total     |
|---------------------------------------|--------------------|-------------|----------------------------|-----------------------|--------------------|----------------|---------------------|-------------|-----------|
| Allowance for loan losses:            |                    |             |                            |                       |                    |                |                     |             |           |
| Individually evaluated for impairment | \$258              | \$28        | \$8                        | \$14                  | \$41               | \$18           | \$-                 | \$-         | \$367     |
| Collectively evaluated for impairment | 1,184              | 573         | 1,236                      | 385                   | 152                | 149            | 108                 | 233         | 4,020     |
| Ending balance                        | \$1,442            | \$601       | \$1,244                    | \$399                 | \$193              | \$167          | \$108               | \$233       | \$4,387   |
| Loans receivable:                     |                    |             |                            |                       |                    |                |                     |             |           |
| Individually evaluated for impairment | \$4,186            | \$1,247     | \$2,956                    | \$180                 | \$404              | \$51           | \$124               | \$-         | \$9,148   |
| Collectively evaluated for impairment | 128,845            | 33,428      | 165,996                    | 46,099                | 12,135             | 16,824         | 19,401              | -           | 422,728   |
| Ending balance                        | \$133,031          | \$34,675    | \$168,952                  | \$46,279              | \$12,539           | \$16,875       | \$19,525            | \$-         | \$431,876 |

The following table summarizes the activity in loan losses for the three months ended September 30, 2015 (in thousands):

|                            | Beginning Allowance | Charge-offs | Recoveries | Provision | Ending Allowance |
|----------------------------|---------------------|-------------|------------|-----------|------------------|
| One-to four- family        | \$ 1,594            | \$ -        | \$ -       | \$ 174    | \$ 1,768         |
| Home equity                | 509                 | -           | 25         | (15 )     | 519              |
| Commercial and multifamily | 1,507               | -           | -          | (166 )    | 1,341            |
| Construction and land      | 345                 | -           | 1          | (229 )    | 117              |
| Manufactured homes         | 193                 | -           | -          | (1 )      | 192              |
| Other consumer             | 183                 | (18 )       | 2          | 2         | 169              |
| Commercial business        | 145                 | -           | -          | (11 )     | 134              |
| Unallocated                | 96                  | -           | -          | 346       | 442              |
| Total                      | \$ 4,572            | \$ (18 )    | \$ 28      | \$ 100    | \$ 4,682         |

The following table summarizes the activity in loan losses for the nine months ended September 30, 2015 (in thousands):

|                     | Beginning Allowance | Charge-offs | Recoveries | Provision | Ending Allowance |
|---------------------|---------------------|-------------|------------|-----------|------------------|
| One-to four- family | \$ 1,442            | \$ (21 )    | \$ -       | \$ 347    | \$ 1,768         |
| Home equity         | 601                 | (19 )       | 35         | (98 )     | 519              |

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|                            |          |           |       |        |          |
|----------------------------|----------|-----------|-------|--------|----------|
| Commercial and multifamily | 1,244    | -         | -     | 97     | 1,341    |
| Construction and land      | 399      | (40 )     | 1     | (242 ) | 117      |
| Manufactured homes         | 193      | (32 )     | 5     | 24     | 192      |
| Other consumer             | 167      | (45 )     | 11    | 37     | 169      |
| Commercial business        | 108      | -         | -     | 26     | 134      |
| Unallocated                | 233      | -         | -     | 209    | 442      |
| Total                      | \$ 4,387 | \$ (157 ) | \$ 52 | \$ 400 | \$ 4,682 |

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the activity in loan losses for the three months ended September 30, 2014 (in thousands):

|                            | Beginning |             |            |           | Ending    |
|----------------------------|-----------|-------------|------------|-----------|-----------|
|                            | Allowance | Charge-offs | Recoveries | Provision | Allowance |
| One-to four- family        | \$ 872    | \$ (51 )    | \$ 64      | \$ 26     | \$ 911    |
| Home equity                | 446       | (187 )      | 15         | 93        | 367       |
| Commercial and multifamily | 1,790     | -           | 1          | 27        | 1,818     |
| Construction and land      | 260       | -           | -          | (21 )     | 239       |
| Manufactured homes         | 137       | (12 )       | 4          | (15 )     | 114       |
| Other consumer             | 87        | (5 )        | 10         | 9         | 101       |
| Commercial business        | 137       | -           | -          | 101       | 238       |
| Unallocated                | 462       | -           | -          | (20 )     | 442       |
| Total                      | \$ 4,191  | \$ (255 )   | \$ 94      | \$ 200    | \$ 4,230  |

The following table summarizes the activity in loan losses for the nine months ended September 30, 2014 (in thousands):

|                            | Beginning |             |            |           | Ending    |
|----------------------------|-----------|-------------|------------|-----------|-----------|
|                            | Allowance | Charge-offs | Recoveries | Provision | Allowance |
| One-to four- family        | \$ 1,915  | \$ (116 )   | \$ 65      | \$ (953 ) | \$ 911    |
| Home equity                | 781       | (295 )      | 48         | (167 )    | 367       |
| Commercial and multifamily | 300       | (46 )       | 2          | 1,562     | 1,818     |
| Construction and land      | 318       | -           | -          | (79 )     | 239       |
| Manufactured homes         | 209       | (189 )      | 9          | 85        | 114       |
| Other consumer             | 109       | (42 )       | 17         | 17        | 101       |
| Commercial business        | 102       | -           | -          | 136       | 238       |
| Unallocated                | 443       | -           | -          | (1 )      | 442       |
| Total                      | \$ 4,177  | \$ (688 )   | \$ 141     | \$ 600    | \$ 4,230  |

Credit Quality Indicators. Federal regulations provide for the classification of lower quality loans as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without establishment of a specific loss reserve is not warranted.

When we classify problem loans as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent to address the risk specifically (if the loan is impaired) or we may allow the loss to be addressed in the general allowance (if the loan is not impaired). General allowances represent loss reserves which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem loans. When the Company classifies problem loans as a loss, we charge off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose us to sufficient risk to warrant classification as substandard, doubtful or loss but possess identified weaknesses are classified as either watch or special mention assets. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the Federal Deposit Insurance Corporation

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(“FDIC”), which can order the establishment of additional loss allowances. Pass rated loans are loans that are not otherwise classified or criticized.

The following table represents the internally assigned grades as of September 30, 2015 by type of loan (in thousands):

|             | One- to<br>four-<br>family | Home<br>equity | Commercial<br>and<br>multifamily | Construction<br>and land | Manufactured<br>homes | Other<br>consumer | Commercial<br>business | Total     |
|-------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Grade:      |                            |                |                                  |                          |                       |                   |                        |           |
| Pass        | \$132,552                  | \$30,389       | \$ 158,763                       | \$ 48,928                | \$ 13,389             | \$ 20,846         | \$ 19,597              | \$424,464 |
| Watch       | 1,477                      | 771            | 3,979                            | 65                       | 168                   | 60                | 1,037                  | 7,557     |
| Special     |                            |                |                                  |                          |                       |                   |                        |           |
| Mention     | 1,410                      | -              | -                                | -                        | 33                    | -                 | 40                     | 1,483     |
| Substandard | 1,692                      | 661            | 1,437                            | 41                       | 42                    | 81                | -                      | 3,954     |
| Doubtful    | -                          | -              | -                                | -                        | -                     | -                 | -                      | -         |
| Loss        | -                          | -              | -                                | -                        | -                     | -                 | -                      | -         |
| Total       | \$137,131                  | \$31,821       | \$ 164,179                       | \$ 49,034                | \$ 13,632             | \$ 20,987         | \$ 20,674              | \$437,458 |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Notes to Condensed Consolidated Financial Statements (unaudited)

The following table represents the internally assigned grades as of December 31, 2014 by type of loan (in thousands):

|             | One- to four- family | Home equity | Commercial and multifamily | Construction and land | Manufactured homes | Other consumer | Commercial business | Total      |
|-------------|----------------------|-------------|----------------------------|-----------------------|--------------------|----------------|---------------------|------------|
| Grade:      |                      |             |                            |                       |                    |                |                     |            |
| Pass        | \$ 120,152           | \$ 30,785   | \$ 163,573                 | \$ 45,427             | \$ 11,427          | \$ 16,587      | \$ 18,919           | \$ 406,870 |
| Watch       | 11,793               | 3,322       | 3,740                      | 852                   | 1,038              | 240            | 606                 | 21,591     |
| Special     |                      |             |                            |                       |                    |                |                     |            |
| Mention     | -                    | -           | -                          | -                     | 24                 | -              | -                   | 24         |
| Substandard | 1,086                | 568         | 1,639                      | -                     | 50                 | 48             | -                   | 3,391      |
| Doubtful    | -                    | -           | -                          | -                     | -                  | -              | -                   | -          |
| Loss        | -                    | -           | -                          | -                     | -                  | -              | -                   | -          |
| Total       | \$ 133,031           | \$ 34,675   | \$ 168,952                 | \$ 46,279             | \$ 12,539          | \$ 16,875      | \$ 19,525           | \$ 431,876 |

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 automatically placed on nonaccrual once the loan is 90 days past due or sooner if, in management's opinion, the borrower may be unable to meet payment of obligations as they become due, as well as when required by regulatory authorities.

The following table presents the recorded investment in nonaccrual loans as of September 30, 2015 and December 31, 2014, by type of loan (in thousands):

|                       | September 30, 2015 | December 31, 2014 |
|-----------------------|--------------------|-------------------|
| One- to four- family  | \$ 1,149           | \$ 1,092          |
| Home equity           | 349                | 258               |
| Construction and land | 41                 | 81                |
| Manufactured homes    | 18                 | 6                 |
| Other consumer        | 75                 | 27                |
| Total                 | \$ 1,632           | \$ 1,464          |

The following table represents the aging of the recorded investment in past due loans as of September 30, 2015 by type of loan (in thousands):

|                            | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days and Greater Past Due | 90 Days and Greater Past Due and Still Accruing | Total Past Due | Current    | Total Loans |
|----------------------------|---------------------|---------------------|------------------------------|---|----------------|------------|-------------|
| One-to four- family        | \$-                 | \$ 340              | \$ 1,149                     | \$ 338  | \$ 1,827       | \$ 135,304 | \$ 137,131  |
| Home equity                | 938                 | 7                   | 299                          | -   | 1,244          | 30,577     | 31,821      |
| Commercial and multifamily | 63                  | -                   | -                            | -   | 63             | 164,116    | 164,179     |
| Construction and land      | -                   | -                   | 41                           | -   | 41             | 48,993     | 49,034      |
| Manufactured homes         | 77                  | 32                  | 5                            | -   | 114            | 13,518     | 13,632      |



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|                     |         |       |         |       |         |           |           |
|---------------------|---------|-------|---------|-------|---------|-----------|-----------|
| Other consumer      | 34      | 4     | 75      | -     | 113     | 20,874    | 20,987    |
| Commercial business | 9       | -     | -       | -     | 9       | 20,665    | 20,674    |
| Total               | \$1,121 | \$383 | \$1,569 | \$338 | \$3,411 | \$434,047 | \$437,458 |

The following table represents the aging of the recorded investment in past due loans as of December 31, 2014 by type of loan (in thousands):

|                            | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90 Days<br>and<br>Greater<br>Past<br>Due | 90 Days<br>and<br>Greater<br>Past<br>Due<br>and<br>Still<br>Accruing | Total<br>Past<br>Due | Current   | Total<br>Loans |
|----------------------------|------------------------------|------------------------------|--|--|----------------------|-----------|----------------|
| One-to four- family        | \$1,300                      | \$167                        | \$720                                    | \$-  | \$2,187              | \$130,844 | \$133,031      |
| Home equity                | 585                          | 109                          | 203                                      | -  | 897                  | 33,778    | 34,675         |
| Commercial and multifamily | -                            | -                            | -  | -  | -                    | 168,952   | 168,952        |
| Construction and land      | -                            | -                            | 81                                       | -  | 81                   | 46,198    | 46,279         |
| Manufactured homes         | 197                          | 42                           | 27                                       | 114  | 380                  | 12,159    | 12,539         |
| Other consumer             | 23                           | 7                            | -  | -  | 30                   | 16,845    | 16,875         |
| Commercial business        | 430                          | -                            | -  | -  | 430                  | 19,095    | 19,525         |
| Total                      | \$2,535                      | \$325                        | \$1,031                                  | \$114  | \$4,005              | \$427,871 | \$431,876      |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

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Nonperforming Loans. Loans are considered nonperforming when they are placed on nonaccrual and/or when they are considered to be nonperforming troubled debt restructurings (“TDRs”) and/or when they are 90 days or greater past due and still accruing. A TDR is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Company is granting the borrower a concession of some kind. Nonperforming TDRs include TDRs that do not have sufficient payment history (typically greater than six months) to be considered performing or TDRs that have become 31 or more days past due.

The following table represents the credit risk profile of our loan portfolio based on payment activity as of September 30, 2015 by type of loan (in thousands):

|               | One- to<br>four-<br>family | Home<br>equity | Commercial<br>and<br>multifamily | Construction<br>and land | Manufactured<br>homes | Other<br>consumer | Commercial<br>business | Total     |
|---------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Performing    | \$135,644                  | \$31,386       | \$ 164,179                       | \$ 48,993                | \$ 13,578             | \$ 20,912         | \$ 20,674              | \$435,366 |
| Nonperforming | 1,487                      | 435            | -                                | 41                       | 54                    | 75                | -                      | 2,092     |
| Total         | \$137,131                  | \$31,821       | \$ 164,179                       | \$ 49,034                | \$ 13,632             | \$ 20,987         | \$ 20,674              | \$437,458 |

The following table represents the credit risk profile of our loan portfolio based on payment activity as of December 31, 2014 by type of loan (in thousands):

|               | One- to<br>four-<br>family | Home<br>equity | Commercial<br>and<br>multifamily | Construction<br>and land | Manufactured<br>homes | Other<br>consumer | Commercial<br>business | Total     |
|---------------|----------------------------|----------------|----------------------------------|--------------------------|-----------------------|-------------------|------------------------|-----------|
| Performing    | \$131,519                  | \$34,289       | \$ 167,313                       | \$ 46,198                | \$ 12,344             | \$ 16,846         | \$ 19,525              | \$428,034 |
| Nonperforming | 1,512                      | 386            | 1,639                            | 81                       | 195                   | 29                | -                      | 3,842     |
| Total         | \$133,031                  | \$34,675       | \$ 168,952                       | \$ 46,279                | \$ 12,539             | \$ 16,875         | \$ 19,525              | \$431,876 |

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 loan. In the process of identifying loans as impaired, we take 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 on a case by case basis, after taking into consideration the totality of circumstances surrounding the loans and the borrowers, including payment history. Impairment is measured on a loan by loan basis for all loans in the portfolio. All TDRs are also classified as impaired loans and are included in the loans individually evaluated for impairment in the calculation of the allowance for loan losses.

The following table presents loans individually evaluated for impairment as of September 30, 2015 by type of loan (in thousands):

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|-------------------------------------|------------------------|--------------------------------|----------------------|
| With no related allowance recorded: |                        |                                |                      |
| One-to four- family                 | \$ 1,134               | \$ 1,487                       | \$ -                 |
| Home equity                         | 156                    | 159                            | -                    |
| Commercial and multifamily          | -                      | -                              | -                    |

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|                             |          |          |          |
|-----------------------------|----------|----------|----------|
| Construction and land       | 41       | 81       | -        |
| Manufactured homes          | 29       | 41       | -        |
| Other consumer              | 75       | 90       | -        |
| Commercial business         | -        | -        | -        |
| Total                       | 1,435    | 1,858    | -        |
| With an allowance recorded: |          |          |          |
| One-to four- family         | 4,850    | 4,525    | 661      |
| Home equity                 | 757      | 851      | 89       |
| Commercial and multifamily  | 1,976    | 1,976    | 183      |
| Construction and land       | 93       | 93       | 18       |
| Manufactured homes          | 333      | 333      | 60       |
| Other consumer              | 6        | 6        | -        |
| Commercial business         | 157      | 157      | 11       |
| Total                       | 8,172    | 7,941    | 1,022    |
| Totals:                     |          |          |          |
| One-to-four family          | 5,984    | 6,012    | 661      |
| Home equity                 | 913      | 1,010    | 89       |
| Commercial and multifamily  | 1,976    | 1,976    | 183      |
| Construction and land       | 134      | 174      | 18       |
| Manufactured homes          | 362      | 374      | 60       |
| Other consumer              | 81       | 96       | -        |
| Commercial business         | 157      | 157      | 11       |
| Total                       | \$ 9,607 | \$ 9,799 | \$ 1,022 |

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents loans individually evaluated for impairment as of December 31, 2014 by type of loan (in thousands):

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|-------------------------------------|------------------------|--------------------------------|----------------------|
| With no related allowance recorded: |                        |                                |                      |
| One-to four- family                 | \$ 2,096               | \$ 2,340                       | \$ -                 |
| Home equity                         | 494                    | 555                            | -                    |
| Commercial and multifamily          | 1,492                  | 1,542                          | -                    |
| Construction and land               | 100                    | 100                            | -                    |
| Manufactured homes                  | 87                     | 94                             | -                    |
| Other consumer                      | 21                     | 21                             | -                    |
| Commercial business                 | 124                    | 124                            | -                    |
| Total                               | 4,414                  | 4,776                          | -                    |
| With an allowance recorded:         |                        |                                |                      |
| One-to four- family                 | 2,090                  | 2,090                          | 258                  |
| Home equity                         | 753                    | 847                            | 28                   |
| Commercial and multifamily          | 1,464                  | 1,464                          | 8                    |
| Construction and land               | 80                     | 80                             | 14                   |
| Manufactured homes                  | 317                    | 317                            | 41                   |
| Other consumer                      | 30                     | 30                             | 18                   |
| Commercial business                 | -                      | -                              | -                    |
| Total                               | 4,734                  | 4,828                          | 367                  |
| Totals:                             |                        |                                |                      |
| One-to four- family                 | 4,186                  | 4,430                          | 258                  |
| Home equity                         | 1,247                  | 1,402                          | 28                   |
| Commercial and multifamily          | 2,956                  | 3,006                          | 8                    |
| Construction and land               | 180                    | 180                            | 14                   |
| Manufactured homes                  | 404                    | 411                            | 41                   |
| Other consumer                      | 51                     | 51                             | 18                   |
| Commercial business                 | 124                    | 124                            | -                    |
| Total                               | \$ 9,148               | \$ 9,604                       | \$ 367               |

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

The following table presents the average recorded investment and interest income recognized on impaired loans by type of loan for the three and nine months ended September 30, 2015 and 2014 (in thousands):

|                                     | Three Months Ended           |                          |                              |                          | Nine Months Ended            |                          |                              |                          |
|-------------------------------------|------------------------------|--------------------------|------------------------------|--------------------------|------------------------------|--------------------------|------------------------------|--------------------------|
|                                     | September 30,<br>2015        |                          | September 30,<br>2014        |                          | September 30,<br>2015        |                          | September 30, 2014           |                          |
|                                     | Average Interest<br>Recorded | Investment<br>Recognized | Average Interest<br>Recorded | Investment<br>Recognized | Average Interest<br>Recorded | Investment<br>Recognized | Average Interest<br>Recorded | Investment<br>Recognized |
| With no related allowance recorded: |                              |                          |                              |                          |                              |                          |                              |                          |
| One-to four- family                 | \$1,688                      | \$ 19                    | \$2,276                      | \$ 22                    | \$1,797                      | \$ 45                    | \$1,444                      | \$ 70                    |
| Home equity                         | 251                          | 2                        | 756                          | 8                        | 387                          | 5                        | 510                          | 24                       |
| Commercial and multifamily          | 125                          | -                        | 2,245                        | 19                       | 756                          | -                        | 2,005                        | 55                       |
| Construction and land               | 41                           | 1                        | 122                          | 1                        | 50                           | -                        | 71                           | 7                        |
| Manufactured homes                  | 29                           | 1                        | 93                           | 2                        | 60                           | 2                        | 92                           | 5                        |
| Other consumer                      | 41                           | 2                        | 19                           | 2                        | 29                           | 1                        | 14                           | 3                        |
| Commercial business                 | -                            | -                        | 127                          | 2                        | 82                           | -                        | 153                          | 5                        |
| Total                               | 2,174                        | 25                       | 5,638                        | 56                       | 3,159                        | 53                       | 4,289                        | 169                      |
| With an allowance recorded:         |                              |                          |                              |                          |                              |                          |                              |                          |
| One-to four- family                 | 4,072                        | 51                       | 2,283                        | 24                       | 3,160                        | 153                      | 3,184                        | 74                       |
| Home equity                         | 755                          | 8                        | 789                          | 8                        | 728                          | 23                       | 1,078                        | 24                       |
| Commercial and multifamily          | 2,263                        | 30                       | 737                          | 21                       | 1,860                        | 78                       | 1,168                        | 59                       |
| Construction and land               | 94                           | 1                        | 82                           | 1                        | 107                          | 4                        | 134                          | 3                        |
| Manufactured homes                  | 337                          | 6                        | 395                          | 7                        | 325                          | 18                       | 474                          | 20                       |
| Other consumer                      | 52                           | -                        | 6                            | -                        | 34                           | 1                        | 12                           | -                        |
| Commercial business                 | 138                          | 2                        | -                            | -                        | 69                           | 5                        | 69                           | -                        |
| Total                               | 7,710                        | 98                       | 4,292                        | 61                       | 6,284                        | 282                      | 6,119                        | 180                      |
| Totals:                             |                              |                          |                              |                          |                              |                          |                              |                          |
| One-to four- family                 | 5,760                        | 70                       | 4,559                        | 46                       | 4,957                        | 198                      | 4,628                        | 144                      |
| Home equity                         | 1,006                        | 10                       | 1,545                        | 16                       | 1,115                        | 28                       | 1,588                        | 48                       |
| Commercial and multifamily          | 2,388                        | 30                       | 2,982                        | 40                       | 2,616                        | 78                       | 3,173                        | 114                      |
| Construction and land               | 135                          | 2                        | 204                          | 2                        | 157                          | 4                        | 205                          | 10                       |
| Manufactured homes                  | 366                          | 7                        | 488                          | 9                        | 385                          | 20                       | 566                          | 25                       |
| Other consumer                      | 93                           | 2                        | 25                           | 2                        | 63                           | 2                        | 26                           | 3                        |
| Commercial business                 | 138                          | 2                        | 127                          | 2                        | 151                          | 5                        | 222                          | 5                        |
| Total                               | \$9,884                      | \$ 123                   | \$9,930                      | \$ 117                   | \$9,443                      | \$ 335                   | \$10,408                     | \$ 349                   |

Forgone interest on nonaccrual loans was \$72,000 and \$61,000 for the nine months ended September 30, 2015 and 2014, respectively. There were no commitments to lend additional funds to borrowers whose loans were classified as nonaccrual, TDR or impaired at September 30, 2015 or December 31, 2014.

Troubled debt restructurings. Loans classified as TDRs totaled \$6.1 million and \$7.7 million at September 30, 2015 and December 31, 2014, respectively, and are included in impaired loans. The Company has granted in its TDRs a variety of concessions to borrowers in the form of loan modifications. The modifications granted can generally be described in the following categories:

Rate Modification: A modification in which the interest rate is changed.

Term Modification: A modification in which the maturity date, timing of payments, or frequency of payments is changed.

Payment Modification: A modification in which the dollar amount of the payment is changed. Interest only modifications in which a loan is converted to interest only payments for a period of time are included in this category.

Combination Modification: Any other type of modification, including the use of multiple categories above.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Notes to Condensed Consolidated Financial Statements (unaudited)

There were no new TDRs that occurred during the nine months ended September 30, 2015

The following table presents new TDRs by type of modification that occurred during the three months ended September 30, 2014 (in thousands):

|                            | Three months ended September 30, 2014 |      |      |         |             |          |
|----------------------------|---------------------------------------|------|------|---------|-------------|----------|
|                            | Number of Modifications               | Rate | Term | Payment | Combination | Total    |
|                            |                                       |      |      |         |             |          |
| Home equity                | 1                                     | \$ - | \$ - | \$ -    | \$ 57       | \$ 57    |
| Commercial and multifamily | 1                                     | -    | -    | -       | 1,473       | 1,473    |
| Total                      | 2                                     | \$ - | \$ - | \$ -    | \$ 1,530    | \$ 1,530 |

The following table presents new TDRs by type of modification that occurred during the nine months ended September 30, 2014 (in thousands):

|                            | Nine months ended September 30, 2014 |      |      |         |             |          |
|----------------------------|--------------------------------------|------|------|---------|-------------|----------|
|                            | Number of Modifications              | Rate | Term | Payment | Combination | Total    |
|                            |                                      |      |      |         |             |          |
| One-to four- family        | 1                                    | -    | -    | -       | 176         | 176      |
| Home equity                | 1                                    | -    | -    | -       | 57          | 176      |
| Commercial and multifamily | 1                                    | -    | -    | -       | 1,473       | 1,473    |
| Total                      | 3                                    | \$ - | \$ - | \$ -    | \$ 1,706    | \$ 1,706 |

There were no post-modification changes for the recorded investment in loans that were recorded as a result of the TDRs for the three and nine months ended September 30, 2015 and 2014, respectively. At September 30, 2015 the Company had no commitments to extend additional credit to borrowers whose loan terms have been modified in TDRs. The allowance for loan losses allocated to TDRs at September 30, 2015 and December 31, 2014 was \$667,000 and \$349,000, respectively.

The following table represents loans modified as TDRs within the previous 12 months for which there was a payment default during the three and nine months ended September 30, 2015 and 2014, respectively (in thousands):

|                            | Three Months Ended September 30, 2015 |        | Nine Months Ended September 30, 2014 |        |
|----------------------------|---------------------------------------|--------|--------------------------------------|--------|
|                            | 2015                                  | 2014   | 2015                                 | 2014   |
| One- to four-family        | \$ -                                  | \$ 176 | \$ -                                 | \$ 176 |
| Commercial and multifamily | -                                     | -      | -                                    | -      |
| Total                      | \$ -                                  | \$ 176 | \$ -                                 | \$ 176 |

For the preceding tables, a loan is considered in default when a payment is 30 days past due. At September 30, 2015, there were no TDRs modified within the previous 12 months that were delinquent or on nonaccrual status.





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## Note 5 – Fair Value Measurements

The following tables present information about the level in the fair value hierarchy for the Company's financial assets and liabilities, whether or not recognized or recorded at fair value as of September 30, 2015 and December 31, 2014 (in thousands):

|                                | September 30, 2015 |                      | Fair Value Measurements |         |         |
|--------------------------------|--------------------|----------------------|-------------------------|---------|---------|
|                                |                    |                      | Using:                  |         |         |
|                                | Carrying Value     | Estimated Fair Value | Level 1                 | Level 2 | Level 3 |
| <b>FINANCIAL ASSETS:</b>       |                    |                      |                         |         |         |
| Cash and cash equivalents      | \$36,669           | \$36,669             | \$36,669                | \$-     | \$-     |
| Available for sale securities  | 7,140              | 7,140                | -                       | 7,140   | -       |
| Loans held for sale            | 772                | 797                  | -                       | 797     | -       |
| Loans                          | 435,829            | 430,652              | -                       | -       | 430,652 |
| Accrued interest receivable    | 1,453              | 1,453                | 1,453                   | -       | -       |
| Bank-owned life insurance, net | 11,661             | 11,661               | -                       | 11,661  | -       |
| Mortgage servicing rights      | 3,226              | 3,226                | -                       | -       | 3,226   |
| FHLB stock                     | 1,558              | 1,558                | -                       | -       | 1,558   |
| <b>FINANCIAL LIABILITIES:</b>  |                    |                      |                         |         |         |
| Non-maturity deposits          | 259,994            | 259,994              | -                       | 259,994 | -       |
| Time deposits                  | 159,581            | 158,624              | -                       | 158,624 | -       |
| Borrowings                     | 24,096             | 24,071               | -                       | 24,071  | -       |
| Accrued interest payable       | 61                 | 61                   | -                       | 61      | -       |

|                                | December 31, 2014 |                      | Fair Value Measurements |         |         |
|--------------------------------|-------------------|----------------------|-------------------------|---------|---------|
|                                |                   |                      | Using:                  |         |         |
|                                | Carrying Value    | Estimated Fair Value | Level 1                 | Level 2 | Level 3 |
| <b>FINANCIAL ASSETS:</b>       |                   |                      |                         |         |         |
| Cash and cash equivalents      | \$29,289          | \$29,289             | \$29,289                | \$-     | \$-     |
| Available for sale securities  | 11,524            | 11,524               | -                       | 9,179   | 2,345   |
| Loans held for sale            | 810               | 828                  | -                       | 828     | -       |
| Loans                          | 430,360           | 423,714              | -                       | -       | 423,714 |
| Accrued interest receivable    | 1,497             | 1,497                | 1,497                   | -       | -       |
| Bank-owned life insurance, net | 11,661            | 11,661               | -                       | 11,661  | -       |
| Mortgage servicing rights      | 3,028             | 3,028                | -                       | -       | 3,028   |
| FHLB Stock                     | 2,224             | 2,224                | -                       | -       | 2,224   |
| <b>FINANCIAL LIABILITIES:</b>  |                   |                      |                         |         |         |
| Non-maturity deposits          | 235,870           | 235,870              | -                       | 235,870 | -       |
| Time deposits                  | 171,939           | 172,334              | -                       | 172,334 | -       |
| Borrowings                     | 30,578            | 30,534               | -                       | 30,534  | -       |
| Accrued interest payable       | 76                | 76                   | -                       | 76      | -       |

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The following table presents the balance of assets measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014 (in thousands):

| <u>Description</u>                    | Fair Value at September 30,<br>2015 |         |         |         |
|---------------------------------------|-------------------------------------|---------|---------|---------|
|                                       | Total                               | Level 1 | Level 2 | Level 3 |
| Municipal bonds                       | \$2,064                             | \$ -    | \$2,064 | \$-     |
| Agency mortgage-backed securities     | 4,608                               | -       | 4,608   | -       |
| Non-agency mortgage-backed securities | 468                                 | -       | -       | 468     |
| Mortgage servicing rights             | 3,226                               | -       | -       | 3,226   |

| <u>Description</u>                    | Fair Value at December 31,<br>2014 |         |         |         |
|---------------------------------------|------------------------------------|---------|---------|---------|
|                                       | Total                              | Level 1 | Level 2 | Level 3 |
| Municipal bonds                       | \$2,083                            | \$ -    | \$2,083 | \$-     |
| Agency mortgage-backed securities     | 7,096                              | -       | 7,096   | -       |
| Non-agency mortgage-backed securities | 2,345                              | -       | -       | 2,345   |
| Mortgage servicing rights             | 3,028                              | -       | -       | 3,028   |

For the three and nine months ended September 30, 2015 and 2014 there were no transfers between Level 1 and Level 2 nor between Level 2 and Level 3.

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Notes to Condensed Consolidated Financial Statements (unaudited)

The following table provides a description of the valuation technique, unobservable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring basis at September 30, 2015:

| Financial Instrument                  | Valuation Technique  | Unobservable Input(s)                        | Range<br>(Weighted Average)    |
|---------------------------------------|----------------------|--|--------------------------------|
| Mortgage Servicing Rights             | Discounted cash flow | Prepayment speed assumption<br>Discount rate | 105-380% (192%)<br>8-12% (10%) |
| Non-agency mortgage-backed securities | Discounted cash flow | Discount rate                                | (8%)                           |

Generally, any significant increases in the constant prepayment rate and discount rate utilized in the fair value measurement of the mortgage servicing rights will result in a negative fair value adjustment (and decrease in the fair value measurement). Conversely, a decrease in the constant prepayment rate and discount rate will result in a positive fair value adjustment (and increase in the fair value measurement). An increase in the weighted average life assumptions will result in a decrease in the constant prepayment rate and conversely, a decrease in the weighted average life will result in an increase of the constant prepayment rate.

The following table provides a reconciliation of assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine months ended September 30, 2015 and 2014 (in thousands):

|                                  | Three Months Ended |                    | Nine Months Ended  |                    |
|----------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                  | September 30, 2015 | September 30, 2014 | September 30, 2015 | September 30, 2014 |
| Beginning balance, at fair value | \$483              | \$2,583            | \$2,345            | \$2,419            |
| OTTI impairment losses           | -                  | -                  | -                  | -                  |
| Principal payments               | (14)               | (93)               | (149)              | (314)              |
| Sales                            | -                  | -                  | (1,702)            | -                  |
| Change in unrealized loss        | (1)                | 15                 | (26)               | 400                |
| Ending balance, at fair value    | \$468              | \$2,505            | \$468              | \$2,505            |

Mortgage servicing rights are measured at fair value using significant unobservable input (Level 3) on a recurring basis and a reconciliation of this asset can be found in Note 6 – Mortgage Servicing Rights.

The following tables present the balance of assets measured at fair value on a nonrecurring basis at the dates indicated (in thousands):

|                             | Fair Value at September 30, 2015 |         |         |         |
|-----------------------------|----------------------------------|---------|---------|---------|
|                             | Total                            | Level 1 | Level 2 | Level 3 |
| OREO and repossessed assets | \$177                            | \$ -    | \$ -    | \$177   |
| Impaired loans              | \$9,607                          | -       | -       | \$9,607 |

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Fair Value at December 31,  
2014

|                             | Total | Level 1 | Level 2 | Level 3 |
|-----------------------------|-------|---------|---------|---------|
| OREO and repossessed assets | \$323 | \$ -    | \$ -    | \$323   |
| Impaired loans              | 9,148 | -       | -       | 9,148   |

There were no liabilities carried at fair value, measured on a recurring or nonrecurring basis, at September 30, 2015 or December 31, 2014.

The following table provides a description of the valuation technique, observable input, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a nonrecurring basis at September 30, 2015:

| Financial Instrument | Valuation Technique(s) | Unobservable Input(s)                               | Range (Weighted Average) |
|----------------------|------------------------|---|--------------------------|
| OREO                 | Market approach        | Adjustment for differences between comparable sales | 5-48% (21%)              |
| Impaired loans       | Market approach        | Adjustment for differences between comparable sales | 0-30% (7%)               |

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY  
Notes to Condensed Consolidated Financial Statements (unaudited)

A description of the valuation methodologies used for impaired loans and OREO is as follows:

**Impaired Loans** - The fair value of collateral dependent loans is based on the current appraised value of the collateral or internally developed models utilizing a calculation of expected discounted cash flows which contain management's assumptions.

**OREO and Repossessed Assets** – The fair value of OREO and repossessed assets is based on the current appraised value of the collateral.

The following methods and assumptions were used to estimate the fair value of other financial instruments:

**Cash and cash equivalents, accrued interest receivable and payable, and advance payments from borrowers for taxes and insurance** - The estimated fair value is equal to the carrying amount.

**AFS Securities** – AFS securities are recorded at fair value based on quoted market prices, if available. If quoted market prices are not available, management utilizes third-party pricing services or broker quotations from dealers in the specific instruments. Level 2 securities include those traded on an active exchange, as well as U.S. government and its agencies securities. Level 3 securities include private label mortgage-backed securities.

**Loans Held for Sale** - Residential mortgage loans held for sale are recorded at the lower of cost or fair value. The fair value of fixed-rate residential loans is based on whole loan forward prices obtained from government sponsored enterprises. At September 30, 2015 and December 31, 2014, loans held for sale were carried at cost.

**Loans** - The estimated fair value for all fixed rate loans is determined by discounting the estimated cash flows using the current rate at which similar loans would be made to borrowers with similar credit ratings and maturities. The estimated fair value for variable rate loans is the carrying amount. The fair value for all loans also takes into account projected loan losses as a part of the estimate.

**Mortgage Servicing Rights** –The fair value of mortgage servicing rights is determined through a discounted cash flow analysis, which uses interest rates, prepayment speeds, discount rates, and delinquency rate assumptions as inputs.

**FHLB stock** - The estimated fair value is equal to the par value of the stock, which approximates fair value.

**Bank-owned Life Insurance** - The estimated fair value is equal to the cash surrender value of policies, net of surrender charges.

**Deposits** - The estimated fair value of deposit accounts (savings, demand deposit, and money market accounts) is the carrying amount. The fair values of fixed-maturity time certificates of deposit are estimated by discounting the estimated cash flows using the current rate at which similar certificates would be issued.

**Borrowings** - The fair value of borrowings are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

**Off-balance-sheet financial instruments** - The fair value for the Company's off-balance-sheet loan commitments are estimated based on fees charged to others to enter into similar agreements taking into account the remaining terms of the agreements and credit standing of the Company's customers. The estimated fair value of these commitments is not significant.

We assume interest rate risk (the risk that general interest rate levels will change) as a result of our normal operations. As a result, the fair values of our financial instruments will change when interest rate levels change, which may be favorable or unfavorable to us. Management attempts to match maturities of assets and liabilities to the extent necessary or possible to minimize interest rate risk. However, borrowers with fixed-rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by establishing early withdrawal penalties for certificates of deposit, creating interest rate floors for certain variable rate loans, adjusting terms of new loans and deposits, by borrowing at fixed rates for fixed terms and investing in securities with terms that mitigate our overall interest rate risk.

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## Note 6 – Mortgage Servicing Rights

The unpaid principal balances of loans serviced for Fannie Mae at September 30, 2015 and December 31, 2014, totaled approximately \$360.1 million and \$357.8 million, respectively, and was not included in the Company's financial statements. We also service loans for other financial institutions. The unpaid principal balances of loans serviced for other financial institutions at September 30, 2015 and December 31, 2014, totaled approximately \$19.1 million and \$14.2 million, respectively, and was not included in the Company's financial statements.

A summary of the change in the balance of mortgage servicing rights during the three and nine months ended September 30, 2015 and 2014 were as follows (in thousands):

|   | Three Months<br>Ended<br>September 30,<br>2015 |         | Nine Months<br>Ended<br>September 30,<br>2014 |         |
|---|--|---------|---|---------|
| Beginning balance, at fair value                                | \$3,028  | \$2,993 | \$3,028                                       | \$2,984 |
| Servicing rights that result from transfers of financial assets | 146  | 157     | 582   | 341     |
| Changes in fair value:  |  |         |   |         |
| Due to changes in model inputs or assumptions <sup>(1)</sup>    | (22 )  | 152     | 152   | 437     |
| Other <sup>(2)</sup>  | 74   | (187 )  | (536 )  | (647 )  |
| Ending balance, at fair value                                   | \$3,226  | \$3,115 | \$3,226                                       | \$3,115 |

<sup>(1)</sup> Represents changes in discount rates and prepayment speed assumptions, which are primarily affected by changes in interest rates

<sup>(2)</sup> Represents changes due to collection or realization of expected cash flows over time.

The key economic assumptions used in determining the fair value of mortgage servicing rights at the dates indicated are as follows:

|  | At September<br>30, |       |
|--|---------------------|-------|
|  | 2015                | 2014  |
| Prepayment speed (Public Securities Association "PSA" model) | 192%                | 196%  |
| Weighted-average life (years)                                | 6.43                | 6.41  |
| Yield to maturity discount rate                              | 10.0%               | 10.0% |

The amount of contractually specified servicing, late and ancillary fees earned and recorded in mortgage servicing income on the Condensed Consolidated Statements of Income was \$202,000 and \$671,000 for the three and nine months ended September 30, 2015, respectively and \$202,000 and \$235,000 for the three and nine months ended September 30, 2014, respectively.

## Note 7 – Commitments and Contingencies

In the normal course of operations, the Company engages in a variety of financial transactions that are not recorded in our financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of

loan commitments and lines of credit.

Note 8 – Borrowings and FHLB Stock

The Company utilizes a loan agreement with the FHLB of Des Moines. The terms of the agreement call for a blanket pledge of a portion of the Company's mortgage and commercial and multifamily portfolio based on the outstanding balance. At September 30, 2015 and December 31, 2014, the amount available to borrow under this credit facility was \$176.0 million and \$133.3 million, respectively. At September 30, 2015, the credit facility was collateralized as follows: one- to four- family mortgage loans with a market value of \$76.5 million, commercial and multifamily mortgage loans with a market value of \$96.7 million and home equity loans with a market value of \$6.7 million. The Company had outstanding borrowings under this arrangement of \$24.1 million and \$30.6 million at September 30, 2015 and December 31, 2014, respectively. Additionally, the Company had outstanding letters of credit from the FHLB with a notional amount of \$42.5 million at both September 30, 2015 and December 31, 2014 to secure public deposits which exceeded the collateral requirements established by the Washington Public Deposit Protection Commission. The remaining amount available to borrow as of September 30, 2015 and December 31, 2014, was \$109.4 million and \$60.3 million, respectively.

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SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

Notes to Condensed Consolidated Financial Statements (unaudited)

As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding FHLB advances. At September 30, 2015 and December 31, 2014, the Company had an investment of \$1.6 million and \$2.2 million, respectively, in FHLB stock. Management periodically evaluates FHLB stock for impairment. Management's determination of whether this investment is impaired is based on its 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.

The Company participates in the Federal Reserve Bank Borrower-in-Custody program, which gives the Company access to the discount window. The terms of the program call for a pledge of specific assets. The Company had unused borrowing capacity of \$25.9 million and \$21.8 million and no outstanding borrowings under this program at September 30, 2015 and December 31, 2014, respectively.

The Company has access to a Fed Funds line of credit from the Pacific Coast Banker's Bank. The line has a two-year term maturing on June 30, 2016 and is renewable biannually. The Company had unused borrowing capacity of \$2.0 million and no outstanding borrowings under this agreement at September 30, 2015 and December 31, 2014.

The Company has access to a Fed Funds line of credit from Zions Bank under a Fed Funds Sweep and Line Agreement established September 26, 2013. The agreement allows access to a Fed Funds line of up to \$9.0 million and requires the Company to maintain cash balances with Zions Bank of \$250,000. The agreement has no maturity date. There were no outstanding borrowings on this line of credit at September 30, 2015 or December 31, 2014.

Note 9 – Earnings Per Common Share

Basic earnings per common share is computed by dividing net income (which has been adjusted for distributed and undistributed earnings to participating securities) by the weighted-average number of common shares outstanding for the period, reduced for average unallocated ESOP shares and average unvested restricted stock awards. Unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method described in ASC 260-10-45-60B. Diluted earnings per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock (such as stock awards and options) were exercised or converted to common stock, or resulted in the issuance of common stock that then shared in the Company's earnings. Diluted earnings per common share is computed by dividing net income by the weighted-average number of common shares outstanding for the period increased for the dilutive effect of unexercised stock options and unvested restricted stock awards. The dilutive effect of the unexercised stock options and unvested restricted stock awards is calculated under the treasury stock method utilizing the average market value of the Company's stock for the period.

Earnings per common share are summarized for the periods presented in the following table (dollars in thousands, except per share data):

| Three Months  | Nine Months   |
|---------------|---------------|
| Ended         | Ended         |
| September 30, | September 30, |

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|   | 2015    | 2014    | 2015    | 2014    |
|---|---------|---------|---------|---------|
| Net income  | \$1,115 | \$1,235 | \$3,570 | \$3,438 |
| Less net income attributable to participating securities <sup>(1)</sup> | 38      | 22      | 118     | 60      |
| Net income available to common shareholders                             | \$1,077 | \$1,213 | \$3,452 | \$3,378 |
| Weighted average number of shares outstanding, basic                    | 2,465   | 2,516   | 2,500   | 2,511   |
| Effect of potentially dilutive common shares <sup>(2)</sup>             | 87      | 93      | 86      | 94      |
| Weighted average number of shares outstanding, diluted                  | 2,552   | 2,609   | 2,586   | 2,605   |
| Earnings per share, basic   | \$0.45  | \$0.49  | \$1.43  | \$1.37  |
| Earnings per share, diluted   | \$0.44  | \$0.47  | \$1.38  | \$1.32  |

<sup>(1)</sup> Represents dividends paid and undistributed earnings allocated to non-vested restricted stock awards.

<sup>(2)</sup> Represents the effect of the assumed exercise of stock options and vesting of non-participating restricted shares, based on the treasury stock method.

There were no shares considered anti-dilutive for the three and nine months ended September 30, 2015 or 2014.

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Notes to Condensed Consolidated Financial Statements (unaudited)

## Note 10 – Stock-based Compensation

## Stock Options and Restricted Stock

The Company currently has two existing Equity Incentive Plans, a 2008 Equity Incentive Plan (the "2008 Plan") and a 2013 Equity Incentive Plan (the "2013 Plan"), both of which were approved by shareholders. The Plans permit the grant of restricted stock, restricted stock units, stock options, and stock appreciation rights. Under the 2008 Plan, 126,287 shares of common stock were approved for awards for stock options and stock appreciation rights and 50,514 shares of common stock were approved for awards for restricted stock and restricted stock units. Under the 2013 Plan, 141,750 shares of common stock were approved for awards for stock options and stock appreciation rights and 56,700 shares of common stock were approved for awards for restricted stock and restricted stock units.

As of September 30, 2015, awards for stock options totaling 188,189 shares and awards for restricted stock totaling 31,553 shares of Company common stock are outstanding. During the three and nine months ended September 30, 2015 and September 30, 2014, share-based compensation expense totaled \$115,000, \$322,000, \$45,000 and \$289,000, respectively.

## Stock Option Awards

All of the stock option awards granted under the Plans to date provide for the recipient's award to vest in 20 percent annual increments commencing one year from the grant date. All of the options granted are exercisable for a period of 10 years from the date of grant, subject to vesting. The following is a summary of the Company's stock option plan awards during the nine months ended September 30, 2015:

|   | Shares   | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term In Years | Aggregate Intrinsic Value |
|---|----------|---------------------------------|--|---------------------------|
| Outstanding at the beginning of the year                              | 152,018  | \$ 13.30                        | 7.21   | \$ 858,902                |
| Granted   | 40,782   | \$ 18.36                        |  |                           |
| Exercised   | (4,611 ) | \$ 9.10                         |  |                           |
| Forfeited   | (1,205 ) | \$ 16.80                        |  |                           |
| Expired   | -        |                                 |  |                           |
| Outstanding at September 30, 2015                                     | 188,189  | \$ 14.45                        |  | \$ 1,067,032              |
| Exercisable   | 87,166   | \$ 12.07                        |  | \$ 701,686                |
| Expected to vest, assuming a 0% forfeiture rate over the vesting term | 188,189  | \$ 14.45                        |  | \$ 1,067,032              |

As of September 30, 2015, there was \$708,000 of total unrecognized compensation cost related to non-vested stock options granted under the Plans. The cost is expected to be recognized over the remaining weighted-average vesting period of 1.7 years.

The fair value of each option award granted is estimated on the date of grant using a Black-Scholes model. The assumptions used for the nine months ended September 30, 2015 are presented in the table below:

|                       |        |
|-----------------------|--------|
| Annual dividend yield | 1.2 %  |
| Expected volatility   | 24.8 % |

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|   |            |
|---|------------|
| Risk-free interest rate                                   | 1.35%      |
| Expected term   | 7.25 years |
| Weighted-average grant date fair value per option granted | \$3.83     |

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## SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY

## Notes to Condensed Consolidated Financial Statements (unaudited)

## Restricted Stock Awards

The fair value of the restricted stock awards is equal to the fair value of the Company's stock at the date of grant. Compensation expense is recognized over the vesting period that the awards are based. The restricted stock awards granted under the 2008 Plan to date provide for vesting in 20 percent annual increments commencing one year from the grant date. The restricted stock awards under the 2013 Plan to date vested 20% of a recipient's award immediately with the balance of an individual's award vestings in four equal annual installments commencing one year from the grant date.

The following is a summary of the Company's outstanding restricted stock awards during the nine months ended September 30, 2015:

|  | Shares   | Weighted-Average<br>Grant-Date Fair<br>Value<br>Per Share |
|--|----------|---|
| Non-vested Shares  |          |   |
| Non-vested at January 1, 2015  | 33,243   | \$ 2.49   |
| Granted  | 10,208   | 3.83  |
| Vested   | (11,416) | 1.94  |
| Forfeited  | (482 )   | 1.31  |
| Expired  | -        | -   |
| Non-vested at September 30, 2015                                     | 31,553   | \$ 1.87   |
| Expected to vest assuming a 0% forfeiture rate over the vesting term | 31,553   | \$ 1.87   |

As of September 30, 2015, there was \$572,000 of unrecognized compensation cost related to non-vested restricted stock granted under the Plan remaining. The cost is expected to be recognized over the weighted-average vesting period of 1.2 years. The total fair value of shares vested for the nine months ended September 30, 2015 and 2014 was \$240,000 and \$269,000, respectively.

## Employee Stock Ownership Plan

In January 2008, the ESOP borrowed \$1.2 million from the Company to purchase common stock of the Company. In August 2012, in conjunction with the Company's "second step" conversion to become a fully converted public company, the ESOP borrowed \$1.1 million from the Company to purchase additional common stock of the Company. Both loans are being repaid principally by the Bank through contributions to the ESOP over a period of ten years. The interest rate on the loans is fixed at 4.0% and 2.25%, per annum, respectively. As of September 30, 2015, the remaining balances of the ESOP loans were \$398,000 and \$808,000, respectively.

Neither the loan balances nor the related interest expense are reflected on the condensed consolidated financial statements.

At September 30, 2015, the ESOP was committed to release 21,443 shares of the Company's common stock to participants and held 109,686 unallocated shares remaining to be released in future years. The fair value of the 194,728 shares of Company common stock held by the ESOP trust was \$3.9 million at September 30, 2015. ESOP compensation expense included in salaries and benefits was \$110,000 and \$313,000 for the three and nine months ended September 30, 2015 and \$78,000 and \$233,000 for the three and nine months ended September 30, 2014, respectively.

Note 11 – Subsequent Event

On October 29, 2015, the Company declared a quarterly cash dividend of \$0.06 per common share, payable November 24, 2015 to shareholders of record at the close of business November 10, 2015.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

Certain matters discussed in this 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:

- changes in economic conditions, either nationally or in our market area;
- fluctuations in interest rates;
- the risks of lending and investing activities, including changes in the level and direction of loan delinquencies and write-offs and changes in estimates of the adequacy of our allowance for loan losses;
- the possibility of other-than-temporary impairments of securities held in our securities portfolio;
- our ability to access cost-effective funding;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties, and fluctuations in real estate values and both residential and commercial and multifamily real estate market conditions in our market area;
- secondary market conditions for loans and our ability to sell loans in the secondary market;
- our ability to attract and retain deposits;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and expected cost savings and other benefits within the anticipated time frames or at all, including, in particular, our recent acquisition of three branches from Columbia State Bank;
- legislative or regulatory changes such as the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations that adversely affect our business, as well as changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including changes related to Basel III;
- monetary and fiscal policies of the Board of Governors of the Federal Reserve System ("Federal Reserve") and the U.S. Government and other governmental initiatives affecting the financial services industry;

results of examinations of Sound Financial Bancorp and Sound Community Bank by their regulators, including the possibility that the regulators may, among other things, require us to increase our allowance for loan losses or to write-down assets, change Sound Community Bank's regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;

·increases in premiums for deposit insurance;

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- our ability to control operating costs and expenses;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- difficulties in reducing risks associated with the loans on our balance sheet;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- computer systems on which we depend could fail or experience a security breach;
- our ability to retain key members of our senior management team;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our business strategies;
- increased competitive pressures among financial services companies;
- changes in consumer spending, borrowing and savings habits;
- the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
- our ability to pay dividends on our common stock;
- adverse changes in the securities markets;
- the 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; and
- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described from time to time in this Form 10-Q and our 2014 Form 10-K and other filings with the SEC.

We wish to advise readers not to place undue reliance on any forward-looking statements and that the factors listed above could materially affect our financial performance and could cause our actual results for future periods to differ materially from any such forward-looking statements expressed with respect to future periods and could negatively affect our stock price performance.

We do not undertake and specifically decline any obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

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### General

Sound Financial Bancorp, a Maryland corporation, is a bank holding company for its wholly owned subsidiary, Sound Community Bank. Substantially all of Sound Financial Bancorp's business is conducted through Sound Community Bank, a Washington state-chartered commercial bank. As a Washington commercial bank, the Bank's regulators are the Washington State Department of Financial Institutions ("WDFI") and the Federal Deposit Insurance Corporation ("FDIC"). The Federal Reserve is the primary federal regulator for Sound Financial Bancorp.

Sound Community Bank's deposits are insured up to applicable limits by the FDIC. At September 30, 2015, Sound Financial Bancorp had total consolidated assets of \$502.0 million, net loans of \$431.1 million, deposits of \$419.6 million and stockholders' equity of \$52.9 million. The shares of Sound Financial Bancorp are traded on The NASDAQ Capital Market under the symbol "SFBC." Our executive offices are located at 2005 5<sup>th</sup> Avenue, Suite 200, Seattle, Washington, 98121.

Our principal business consists of attracting retail and commercial deposits from the general public and investing those funds, along with borrowed funds, in loans secured by first and second mortgages on one- to four-family residences (including home equity loans and lines of credit), commercial and multifamily, consumer and commercial business loans and construction and land loans. We offer a variety of secured and unsecured consumer loan products, including manufactured home loans, floating home loans, automobile loans, boat loans and recreational vehicle loans. As part of our business, we focus on residential mortgage loan originations, many of which we sell to Fannie Mae. We sell the majority of these loans with servicing retained to maintain the direct customer relationship and to continue providing strong customer service to our borrowers. We originate and retain a significant amount of commercial real estate loans, including those secured by owner-occupied and nonowner-occupied commercial real estate, multifamily property, manufactured home parks and construction and land development loans.

### Critical Accounting Policies

Certain of our accounting policies are important to an understanding of our financial condition, since they require management to make difficult, complex or subjective judgments, which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances that could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, accounting for other-than-temporary impairment of securities, accounting for mortgage servicing rights, accounting for other real estate owned and accounting for deferred income taxes. Our methodologies for analyzing the allowance for loan losses, mortgage servicing rights, other real estate owned and deferred tax asset accounts are described in our 2014 Form 10-K. There have been no significant changes in the Company's application of accounting policies since December 31, 2014.

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

**General.** Total assets increased \$6.8 million, or 1.4%, to \$502.0 million at September 30, 2015 from \$495.2 million at December 31, 2014. This increase was primarily the result of a \$7.4 million, or 25.2%, increase in cash and cash equivalents and a \$5.2 million, or 1.2%, increase in the net loan portfolio. These increases were primarily offset by a \$4.4 million, or 38%, decrease in our available-for-sale securities and a \$38,000, or 4.7%, decrease in loans held for sale. Excess liquidity from a \$11.8 million, or 2.9%, increase in deposits was primarily used to fund \$5.5 million of loan growth and pay down borrowings by \$6.5 million.

**Cash and Securities.** Cash and cash equivalents increased \$7.4 million, or 25.2%, to \$36.7 million at September 30, 2015 from \$29.3 million at December 31, 2014. Available-for-sale securities, decreased \$4.4 million, or 38.0%, from

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\$11.5 million at December 31, 2014 to \$7.1 million at September 30, 2015 as a result of principal repayments and a \$1.7 million sale of non-agency mortgage-backed securities during the first quarter of 2015.

Loans. Our gross loan portfolio, before deferred fees and allowance for loan losses, increased \$5.6 million, or 1.3%, to \$437.5 million at September 30, 2015 from \$431.9 million at December 31, 2014.

The following table reflects the changes in the types of loans in our portfolio at September 30, 2015, as compared to December 31, 2014 (dollars in thousands):

|   | September 30, 2015 | December 31, 2014 | Amount Change | Percent Change |
|---|--------------------|-------------------|---------------|----------------|
| One-to-four-family  | \$ 137,131         | \$ 133,031        | \$ 4,100      | 3.1 %          |
| Home equity   | 31,821             | 34,675            | (2,854)       | (8.2 )         |
| Commercial and multifamily                                      | 164,179            | 168,952           | (4,773)       | (2.8 )         |
| Construction and land   | 49,034             | 46,279            | 2,755         | 6.0            |
| Manufactured homes  | 13,632             | 12,539            | 1,093         | 8.7            |
| Other consumer  | 20,987             | 16,875            | 4,112         | 24.4           |
| Commercial business   | 20,674             | 19,525            | 1,149         | 5.9            |
| Total loans, before deferred fees and allowance for loan losses | \$ 437,458         | \$ 431,876        | \$ 5,582      | 1.29 %         |

The increases in our loan portfolio were primarily a result of our loan production exceeding loan pay downs and pay-offs. At September 30, 2015, our loan portfolio remained well-diversified with commercial and multifamily real estate loans accounting for 37.5% of the portfolio. Residential real estate loans accounted for 31.3% of the portfolio and home equity, manufactured and other consumer loans accounted for 15.2% of the portfolio. Construction and land loans accounted for 11.2% of the portfolio and commercial business loans accounted for the remaining 4.7% of total loans.

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**Mortgage Servicing Rights.** At September 30, 2015 and December 31, 2014, we had \$3.2 million and \$3.0 million, respectively, in mortgage servicing rights recorded at fair value. We record mortgage servicing rights on loans sold to Fannie Mae and other financial institutions with servicing retained and upon acquisition of a servicing portfolio. We stratify our capitalized mortgage servicing rights based on the type, term and interest rates of the underlying loans. Mortgage servicing rights are carried at fair value. If the fair value of our mortgage servicing rights fluctuates significantly, our financial results could be materially impacted.

**Nonperforming Assets.** At September 30, 2015, nonperforming assets totaled \$2.3 million, or 0.5% of total assets, compared to \$4.2 million, or 0.84% of total assets at December 31, 2014.

The table below sets forth the amounts and categories of nonperforming assets at the dates indicated (dollars in thousands):

|   | Nonperforming Assets           |                               |                  |                   |
|---|--------------------------------|-------------------------------|------------------|-------------------|
|   | At<br>September<br>30,<br>2015 | At<br>December<br>31,<br>2014 | Amount<br>Change | Percent<br>Change |
| Nonaccrual loans                          | \$1,632                        | \$ 1,464                      | \$ 168           | 11.5 %            |
| Accruing loans 90 days or more delinquent | 338                            | 114                           | 224              | 196.5             |
| Nonperforming TDRs                        | 121                            | 2,264                         | (2,143)          | -94.7             |
| Total nonperforming loans                 | 2,091                          | 3,842                         | (1,751)          | -45.6             |
| OREO and repossessed assets               | 177                            | 323                           | (146 )           | -45.1             |
| Total nonperforming assets                | \$2,268                        | \$ 4,165                      | \$(1,897)        | -45.5 %           |

Nonperforming loans, consisting of nonaccrual loans, accruing loans 90 days or more delinquent and nonperforming TDRs, to total loans decreased to \$2.1 million or 0.48% of total loans at September 30, 2015 from \$3.8 million or 0.89% of total loans at December 31, 2014. This decrease reflects a \$2.1 million decline in nonperforming TDRs during the nine months ended September 30, 2015 primarily due to a nonperforming TDR being paid off during the period. Our largest nonperforming loan at September 30, 2015 was a \$324,000 one- to four- family residence.

OREO and repossessed assets decreased during the nine months ended September 30, 2015, due primarily to the sale of one- to four-family properties valued at \$151,000 and the repossession of two manufactured homes valued at \$56,000. The aggregate gain (loss) on all sales during the three and nine months ended September 30, 2015 was (\$22,000) and (\$44,000), respectively. Our largest OREO property at September 30, 2015 consisted of a one- to four-family property with a recorded value of \$124,000 located in Washington County, Washington.

**Allowance for Loan Losses.** The allowance for loan losses is maintained to cover losses that are probable and can be estimated on the date of evaluation in accordance with generally accepted accounting principles in the United States. It is our best estimate of probable incurred credit losses in our loan portfolio. The increase in the allowance for loan losses compared to the comparable period last year was primarily due to increased loan balances and lower net charge-offs.

Our allowance for loan losses at September 30, 2015 was \$4.7 million, or 1.07% of gross loans receivable compared to \$4.4 million, or 1.02% of total loans receivable at December 31, 2014. The allowance for loan losses includes the \$400,000 provision for loan losses established during the nine months ended September 30, 2015.

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The following table reflects the adjustments in our allowance during the periods indicated (dollars in thousands):

|   | At and For the<br>Three Months<br>Ended<br>September 30,<br>2015 |         | At and For the<br>Nine Months<br>Ended<br>September 30,<br>2014 |         |
|---|--|---------|---|---------|
| Balance at beginning of period  | \$4,572  | \$4,191 | \$4,387   | \$4,177 |
| Charge-offs   | (18 )  | (255 )  | (157 )  | (688 )  |
| Recoveries:   | 28   | 94      | 52  | 141     |
| Net recoveries (charge-offs)  | 10   | (161 )  | (105 )  | (547 )  |
| Provisions charged to operations  | 100  | 200     | 400   | 600     |
| Balance at end of period  | \$4,682  | \$4,230 | \$4,682   | \$4,230 |
| Ratio of net charge-offs during the period to average loans outstanding during the period | -0.01 %  | 0.16 %  | 0.03 %  | 0.18 %  |
| All Allowance as a percentage of nonperforming loans                                      | 223.8%   |         | 114.19%   |         |
| All Allowance as a percentage of total loans (end of period)                              | 1.07 %   |         | 1.02 %  |         |

Specific loan loss reserves increased \$655,000 at September 30, 2015 compared to December 31, 2014, while general loan loss reserves decreased \$360,000 at September 30, 2015, compared to December 31, 2014. The increase in specific loan loss reserves was primarily due to a change in valuation methods on a commercial real estate loan from cash flow to collateral value resulting in a lower valuation. The decrease in general loan loss reserves was due to the improved credit quality of the loan portfolio. Net charge-offs for the nine months ended September 30, 2015 were \$105,000, or 0.03%, of average loans on an annualized basis, compared to \$547,000, or 0.18% of average loans on an annualized basis for the same period in 2014. The decrease in net charge-offs was primarily due to improving economic conditions in our market area and continued efforts in credit administration. As of September 30, 2015, the allowance for loan losses as a percentage of total loans receivable and nonperforming loans was 1.07% and 223.8%, respectively, compared to 1.02% and 114.19%, respectively, at December 31, 2014. The allowance for loan losses as a percentage of nonperforming loans improved due to a \$1.8 million decrease in nonperforming loans to \$2.1 million at September 30, 2015 from \$3.8 million at December 31, 2014.

Deposits. Total deposits increased \$11.8 million, or 2.9%, to \$419.6 million at September 30, 2015 from \$407.8 million at December 31, 2014, primarily as a result of a \$16.5 million, or 16.1%, increase in interest-bearing demand accounts, a \$5.5 million, or 13.3% increase in noninterest-bearing demand accounts, and a \$3.8 million, or 11.3%, increase in savings accounts. These increases were partially offset by a \$1.8 million, or 3.2%, decrease in money market accounts and a \$12.4 million, or 7.2%, decrease in certificates of deposit. The increases were the result of retail sales efforts during the period as we continued our emphasis on attracting low-cost core deposit accounts. The decrease in money market and certificate of deposit accounts was primarily the result of some customers shifting these funds into interest-bearing demand accounts. At September 30, 2015, brokered deposits were \$5.8 million compared to \$5.0 million at December 31, 2014.

A summary of deposit accounts with the corresponding weighted average cost of funds is presented below (dollars in thousands):

| As of<br>September 30,<br>2015<br>Amount | As of<br>December 31,<br>2014<br>Amount |
|--|---|
|--|---|

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|                              |           | Wtd.<br>Avg.<br>Rate  |           | Wtd.<br>Avg.<br>Rate |
|------------------------------|-----------|-----------------------|-----------|----------------------|
| Noninterest-bearing checking | \$47,311  | 0.00 %                | \$41,773  | 0.00 %               |
| Interest-bearing checking    | 119,589   | 0.30                  | 103,048   | 0.43                 |
| Savings                      | 36,991    | 0.04                  | 33,233    | 0.16                 |
| Money market                 | 53,475    | 0.20                  | 55,236    | 0.27                 |
| Certificates                 | 159,581   | 1.10 <sup>(1)</sup>   | 171,939   | 1.03                 |
| Escrow                       | 2,628     | 0.00                  | 2,580     | 0.00                 |
| Total deposits               | \$419,575 | 0.53 % <sup>(1)</sup> | \$407,809 | 0.60 %               |

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<sup>(1)</sup> Includes the amortization expense from the deposit premium paid on the purchase of deposits from Columbia State Bank in the third quarter of 2014.

Borrowings. FHLB advances decreased \$6.5 million, or 21.2%, to \$24.1 million at September 30, 2015, with a weighted-average cost of 0.40%, from \$30.6 million at December 31, 2014, with a weighted-average cost of 0.64%. The decrease in average rate was due to a greater percentage of short term borrowings in the current period compared to December 31, 2014. Excess funds from increased deposits and loan repayments during the nine months ended September 30, 2015 were used to reduce borrowings. We rely on FHLB advances to fund interest-earning assets when deposits alone cannot fully fund interest-earning asset growth. This reliance on borrowings, rather than deposits, may increase our overall cost of funds.

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Stockholders' Equity. Total stockholders' equity increased \$2.3 million, or 4.5%, to \$52.9 million at September 30, 2015 from \$50.6 million at December 31, 2014. This increase primarily reflects \$3.6 million in net income for the nine months ended September 30, 2015, partially offset by \$1.3 million in stock repurchases (at an average price of \$19.84 per share) and the payment of cash dividends of \$426,000 to common stockholders.

Comparison of Results of Operation for the Three and Nine Months Ended September 30, 2015 and 2014

General. Net income was \$1.1 million, or \$0.44 per diluted common share, for the three months ended September 30, 2015, a decrease of \$120,000 from the three months ended September 30, 2014. The primary reasons for the decrease in the three months ended September 30, 2015 compared to the same period last year were a decrease in noninterest income and an increase in noninterest expense, which were partially offset by an increase in net interest income and a decrease in the provision. Net income increased \$133,000 to \$3.6 million, or \$1.38 per diluted common share, for the nine months ended September 30, 2015, compared to \$3.4 million, or \$1.32 per diluted common share, for the nine months ended September 30, 2014. The primary reasons for the improvement in net income during the nine month period was an increase in net interest income, a lower provision for loan losses and an increase in noninterest income which was partially offset by an increase in noninterest expense.

Interest Income. Interest income increased \$181,000, or 3.4%, to \$5.6 million for the three months ended September 30, 2015, from \$5.4 million for the three months ended September 30, 2014. Interest income increased \$525,000, or 3.3%, to \$16.4 million for the nine months ended September 30, 2015, from \$15.8 million for the nine months ended September 30, 2014. The increase in interest income for both the three and nine months ended September 30, 2015, primarily reflected the increase in the average balance of interest-earning assets. In particular, our average balance of loans receivable outpaced the decline in the weighted average yield on our interest-earning assets during the three and nine months ended September 30, 2015 as compared to the same periods last year.

Our weighted average yield on interest-earning assets was 4.7% and 4.7% for the three and nine months ended September 30, 2015, respectively, compared to 5.00% and 5.01% for the three and nine months ended September 30, 2014, respectively. The weighted average yield on loans decreased to 5.04% and 5.00% for the three and nine months ended September 30, 2015, respectively, from 5.19% and 5.20% for the three and nine months ended September 30, 2014, respectively. The weighted average yield on available-for-sale securities (including OTTI) was 2.08% and 2.16% for the three and nine months ended September 30, 2015, respectively, compared to 1.65% and 1.41% for the three and nine months ended September 30, 2014, respectively. The decline in the average yield for the loan portfolio was due to the lower interest rate environment and the addition of new loans at lower average rates than those in the portfolio as of December 31, 2014.

Interest Expense. Interest expense increased \$73,000, or 11.9%, to \$685,000 for the three months ended September 30, 2015, from \$612,000 for the three months ended September 30, 2014. Interest expense increased \$237,000, or 13.0%, to \$2.1 million for the nine months ended September 30, 2015, from \$1.8 million for the nine months ended September 30, 2014. The average balances of FHLB advances for the three and nine months ended September 30, 2015, decreased as compared to the same periods last year. Our weighted average cost of interest-bearing liabilities was 0.67% and 0.68% for the three and nine months ended September 30, 2015, respectively, compared to 0.68% and 0.57% for the three and nine months ended September 30, 2014, respectively.

Interest expense on deposits increased \$82,000, or 14.1%, to \$662,000 for the three months ended September 30, 2015, from \$580,000 for the three months ended September 30, 2014. Interest expense on deposits increased \$292,000, or 17.3%, to \$2.0 million for the nine months ended September 30, 2015, from \$1.7 million for the nine months ended September 30, 2014. These increases resulted from higher average balances of deposits outstanding of \$425.3 million and \$419.0 million for the three and nine months ended September 30, 2015, respectively, as compared to the same periods last year. Our weighted average cost of deposits during the three and nine months ended September 30, 2015 was 0.62% and 0.63%, respectively, as compared to 0.60% and 0.61% during the three and

nine months ended September 30, 2014, respectively. The increase in average rates during the three and nine months ended September 30, 2015 was primarily a result of the re-pricing of matured certificates of deposit.

Interest expense on borrowings decreased \$9,000, or 28.1%, to \$23,000 for the three months ended September 30, 2015, from \$32,000 for the three months ended September 30, 2014. Interest expense on borrowings decreased \$56,000, or 44.4%, to \$70,000 for the nine months ended September 30, 2015, from \$126,000 for the nine months ended September 30, 2014. The decrease was a result of a decrease in our cost of borrowings which was 0.40% and 0.45% for the three and nine months ended September 30, 2015, respectively, as compared to 0.64% and 0.57% for the three and nine months ended September 30, 2014, respectively.

Net Interest Income. Net interest income increased \$108,000, or 2.3%, to \$4.9 million for the three months ended September 30, 2015, from \$4.8 for the three months ended September 30, 2014. Net interest income increased \$289,000, or 2.1%, to \$14.3 million for the nine months ended September 30, 2015, from \$14.0 million for the nine months ended September 30, 2014. The increase for three and nine months ended September 30, 2015 resulted from increased interest income due to higher average loan balances. Our average yield on loans receivable decreased during the three and nine months ended September 30, 2015 as compared to the same periods last year as new loan originations are pricing lower than pay downs and paid loans which reflects the continued low rate environment. Our net interest margin was 4.12% and 4.10% for the three and nine months ended September 30, 2015, respectively, compared to 4.43% for both the three and nine months ended September 30, 2014.

Provision for Loan Losses. We establish provisions for loan losses, which are charged to earnings, at a level required to reflect management's best estimate of the probable incurred credit losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect borrowers' ability to repay, estimated value of any underlying collateral, peer group data, prevailing economic conditions, and current factors. Large groups of smaller balance homogeneous loans, such as one-to four-family, small commercial and multifamily, home equity and consumer loans, are evaluated in the aggregate using historical loss factors adjusted for current economic conditions and other relevant data. Loans for which management has concerns about the borrowers' ability to repay, are evaluated individually, and specific loss allocations are provided for these loans when necessary.



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A provision of \$100,000 and \$400,000 was made during the three and nine months ended September 30, 2015, respectively, compared to a provision of \$200,000 and \$600,000 during the three and nine months ended September 30, 2014, respectively. The reduced provision during the nine months ended September 30, 2015 as compared to the same period last year, primarily reflects improvements in our credit metrics partially offset by higher average loan balances and changes in the composition of our loan portfolio.

For the three months ended September 30, 2015, the annualized percentage of net charge-offs to average loans decreased 15 basis points to -0.01%, from 0.16% for the three months ended September 30, 2014. For the nine months ended September 30, 2015, the annualized percentage of net charge-offs to average loans decreased 15 basis points to 0.03%, from 0.18% for the nine months ended September 30, 2014.

The ratio of nonperforming loans to total loans decreased 38 basis points to 0.47% at September 30, 2015 from 0.85% at September 30, 2014.

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 not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of our allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

Noninterest Income. Noninterest income decreased \$165,000, or 11.5%, to \$1.3 million for the three months ended September 30, 2015, as compared to \$1.4 million for the three months ended September 30, 2014 as reflected below (dollars in thousands):

|  | Three Months Ended |                    | Amount Change | Percent Change |
|--|--------------------|--------------------|---------------|----------------|
|  | September 30, 2015 | September 30, 2014 |               |                |
| Service charges and fee income                     | \$641              | \$805              | \$ (164 )     | (20.4 )%       |
| Earnings on cash surrender value of BOLI           | 85                 | 87                 | (2 )          | (2.3 )%        |
| Mortgage servicing income                          | 202                | 202                | 0             |                |
| Fair value adjustment on mortgage servicing rights | (22 )              | 153                | (175 )        | (114.4)%       |
| Net gain on sale of loans                          | 360                | 184                | 176           | 95.7           |
| Total noninterest income                           | \$1,266            | \$1,431            | \$ (165 )     | (11.5 )%       |

Service charges and fee income declined due to lower loan fees for the three months ended September 30, 2015 compared to the same period in 2014. The decrease in the fair value adjustment on mortgage servicing rights was primarily a result of the duration on the underlying loans being projected to shorten due to increased refinance activity. The increase in gain on sale of loans was primarily reflective of higher volumes and average premiums on loans sold.

Noninterest income increased \$808,000, or 24.2%, to \$4.1 million for the nine months ended September 30, 2015, as compared to \$3.3 million for the nine months ended September 30, 2014 as reflected below (dollars in thousands):

|  | Nine Months Ended  |                    | Amount Change | Percent Change |
|--|--------------------|--------------------|---------------|----------------|
|  | September 30, 2015 | September 30, 2014 |               |                |

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|  |         |         |          |          |
|--|---------|---------|----------|----------|
| Service charges and fee income                     | \$1,958 | \$2,040 | \$ (82 ) | -4.0 %   |
| Earnings on cash surrender value of BOLI           | 253     | 253     | 0        |          |
| Mortgage servicing income                          | 671     | 235     | 436      | 185.5 %  |
| Fair value adjustment on mortgage servicing rights | 147     | 437     | (290 )   | (66.3 )% |
| Other-than-temporary impairment losses             | (31 )   | -       | (31 )    |          |
| Net gain on sale of loans                          | 1,146   | 371     | 775      | 208.9 %  |
| Total noninterest income                           | \$4,144 | \$3,336 | \$ 808   | 24.2 %   |

Mortgage servicing income increased due to the increase in volume of loans being serviced by the Bank. The decrease in the fair value adjustment on mortgage servicing rights was primarily a result of the duration on the underlying loans being projected to shorten due to the increased refinance activity. The increase in gain on sale of loans was primarily reflective of higher volumes and average premiums on loans sold.

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Noninterest Expense. Noninterest expense increased \$188,000, or 4.5%, to \$4.4 million during the three months ended September 30, 2015 as compared to \$4.2 million during the three months ended September 30, 2014, as reflected below (dollars in thousands):

|  | Three Months Ended |                    | Amount Change | Percent Change |   |
|--|--------------------|--------------------|---------------|----------------|---|
|  | September 30, 2015 | September 30, 2014 |               |                |   |
| Salaries and benefits                              | \$2,251            | \$1,998            | \$ 253        | 12.7           | % |
| Operations   | 1,064              | 1,155              | (91 )         | (7.9)          | % |
| Regulatory assessments                             | 180                | 66                 | 114           | 172.7          | % |
| Occupancy  | 413                | 381                | 32            | 8.4            | % |
| Data processing                                    | 378                | 606                | (228 )        | (37.6)         | % |
| Losses and expenses on OREO and repossessed assets | 96                 | (12 )              | 108           | 900.0          | % |
| Total noninterest expense                          | \$4,382            | \$4,194            | \$ 188        | 4.5            | % |

Salaries and benefits expense increased during the three months ended September 30, 2015, primarily due to additional full time equivalent employees compared to the same period in 2014. Regulatory assessments increased due to the fee structure utilized by the Washington State Department of Financial Institutions, for providing services to the Bank compared to the former regulatory agency that provided those services. Data processing expenses decreased primarily due to data processing expenses incurred in the three months ended September 30, 2014 related to the acquisition of three branches and data conversion for the accounts acquired in this transaction. Losses and expenses on OREO and repossessed assets increased primarily due to expenses incurred to prepare a property for sale and a valuation write-down on one property.

Noninterest expense increased \$1.1 million, or 9.4%, to \$12.8 million during the nine months ended September 30, 2015 as compared to \$11.7 million during the nine months ended September 30, 2014, as reflected below (dollars in thousands):

|  | Nine Months Ended  |                    | Amount Change | Percent Change |   |
|--|--------------------|--------------------|---------------|----------------|---|
|  | September 30, 2015 | September 30, 2014 |               |                |   |
| Salaries and benefits                              | \$6,711            | \$6,023            | \$ 688        | 11.4           | % |
| Operations   | 3,021              | 3,056              | (35 )         | -1.1           |   |
| Regulatory assessments                             | 476                | 201                | 275           | 136.8          |   |
| Occupancy  | 1,186              | 994                | 192           | 19.3           |   |
| Data processing                                    | 1,233              | 1,278              | (45 )         | -3.45          |   |
| Losses and expenses on OREO and repossessed assets | 178                | 149                | 29            | 19.5           |   |
| Total noninterest expense                          | \$12,805           | \$11,701           | \$ 1,104      | 9.4            | % |

Salaries and benefits expense increased during the nine months ended September 30, 2015, primarily due to a net increase of three full time equivalent employees during the period. Regulatory assessments increased due to the fee structure utilized by the Washington State Department of Financial Institutions, for providing services to the Bank compared to the former regulatory agency that provided those services. .Occupancy expenses increased due to the operation of an additional branch for the full nine months ended September 30, 2015 compared to only two of the nine months ended September 30, 2014.

Income Tax Expense. For the three and nine months ended September 30, 2015, we incurred income tax expense of \$560,000 and \$1.7 million on our pre-tax income as compared to \$585,000 and \$1.6 million for the three and nine

months ended September 30, 2014, respectively. The effective tax rates for the three and nine months ended September 30, 2015 were 33.3% and 32.0%, respectively. The effective tax rates for the three and nine months ended September 30, 2014 were 32.1% and 32.0%, respectively.

## Liquidity

The Management Discussion and Analysis in Item 7 of the Company's 2014 Form 10-K contains an overview of the Company's and the Bank's liquidity management, sources of liquidity and cash flows. This discussion updates that disclosure for the nine months ended September 30, 2015.

The Bank's primary sources of funds are deposits, principal and interest payments on loans and borrowings. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank's primary investing activity is loan originations. The Bank maintains liquidity levels it believes to be adequate to fund loan commitments, investment opportunities, deposit withdrawals and other financial commitments. At September 30, 2015, the Bank had \$43.8 million in cash and investment securities available for sale and \$772,000 in loans held for sale generally available for its cash needs. Also, based on existing collateral pledged, the Bank had the ability to borrow an additional \$109.5 million in Federal Home Loan Bank advances, \$25.9 million through the Federal Reserve's Discount Window, \$9.0 million through a Fed Funds line at Zions Bank and \$2.0 million through a Fed Funds line at Pacific Coast Banker's Bank. The Bank uses these sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At September 30, 2015, outstanding loan commitments, including unused lines and letters of credit totaled \$61.0 million. Certificates of deposit scheduled to mature in one year or less at September 30, 2015, totaled \$91.9 million. Based on our competitive pricing, we believe that a majority of maturing deposits will remain with the Bank.

Cash and cash equivalents increased \$7.4 million to \$36.7 million as of September 30, 2015, from \$29.2 million as of December 31, 2014. Net cash provided from operating activities was \$4.5 million for the nine months ended September 30, 2015. Net cash of \$1.2 million was used in investing activities during the nine months ended September 30, 2015 and consisted principally of loan originations, net of principal repayments. The \$4.0 million of cash provided by financing activities during the nine months ended September 30, 2015 was primarily a result of an \$11.8 million net increase in deposits which was primarily used to fund loan growth, pay down \$6.5 million in FHLB advances and increase on-balance sheet cash.

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As a separate legal entity from the Bank, the Company must provide for its own liquidity. At September 30, 2015, the Company, on an unconsolidated basis, had \$314,000 in cash, noninterest-bearing deposits and liquid investments generally available for its cash needs. The Company's principal source of liquidity is dividends from the Bank.

Except as set forth above, management is not aware of any trends, events, or uncertainties that will have, or that are reasonably likely to have a material impact on liquidity, capital resources or operations.

Off-Balance Sheet Activities

In the normal course of operations, we engage in a variety of financial transactions that are not recorded in our financial statements. These transactions involve varying degrees of off-balance sheet credit, interest rate and liquidity risks. These transactions are used primarily to manage customers' requests for funding and take the form of loan commitments and lines of credit. For the nine months ended September 30, 2015, we engaged in no off-balance sheet transactions likely to have a material effect on our financial condition, results of operations or cash flows.

A summary of our off-balance sheet loan commitments at September 30, 2015, is as follows (in thousands):

|  | At<br>September<br>30,<br>2015 |
|--|--------------------------------|
| <u>Off-balance sheet loan commitments:</u> |                                |
| Residential mortgage commitments           | \$ 4,749                       |
| Undisbursed portion of loans originated    | 41,015                         |
| Unused lines of credit                     | 19,837                         |
| Irrevocable letters of credit              | 185                            |
| Total loan commitments                     | \$ 65,786                      |

Capital

Sound Community Bank is subject to minimum capital requirements imposed by regulations of the FDIC. Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), the Bank became subject to new minimum capital adequacy adopted by the FDIC, which creates a new required ratio for common equity Tier 1 ("CET1") capital, increases the leverage and Tier 1 capital ratios, changes the risk-weightings of certain assets for purposes of the risk-based capital ratios, creates an additional capital conservation buffer over the required capital ratios and changes what qualifies as capital for purposes of meeting these various capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by bank regulators that, if undertaken, could have a direct material effect on the Company's financial statements. The Bank is also required to maintain additional levels of CET1 over the minimum risk-based capital levels before it may pay dividends, repurchase shares or pay discretionary bonuses.

The new minimum requirements are a ratio of CET1 to total risk-weighted assets ("CET1 risk-based ratio") of 4.5%, a Tier 1 capital ratio of 6.0%, a total capital ratio of 8.0%, and a leverage ratio of 4.0%.

In addition to the capital requirements, there are a number of changes in what constitutes regulatory capital, subject to a certain transition periods. These changes include the phasing-out of certain instruments as qualifying capital. The Bank does not have any of these instruments. Mortgage servicing and deferred tax assets over designated percentages of CET1 are be deducted from capital, subject to a transition period ending December 31, 2017. CET1 consists of Tier 1 capital less all capital components that are not considered common equity. In addition, Tier 1 capital includes accumulated other comprehensive income, which includes all unrealized gains and losses on available for sale debt and equity securities, subject to a transition period end December 31, 2017. Because of our asset size, we are not are

considered an "advanced approaches banking organization" and have elected to permanently opt-out of the inclusion of unrealized gains and losses on available for sale debt and equity securities in our capital calculations.

The new requirements also include changes in the risk-weighting of assets to better reflect credit risk and other risk exposure. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in nonaccrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%); and a 250% risk weight (up from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital.

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will be required to maintain a capital conservation buffer consisting of additional CET1 capital equal to 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. This new capital conservation buffer requirement is to be phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented in January 2019.

Under the new standards, in order to be considered well-capitalized, the Bank must have to have a CET1 risk-based ratio of 6.5% (new), a Tier 1 risk-based ratio of 8% (increased from 6%), a total risk-based capital ratio of 10% (unchanged) and a leverage ratio of 5% (unchanged).

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Based on its capital levels at September 30, 2015, Sound Community Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for Sound Community Bank to maintain a "well-capitalized" status under the regulatory capital categories of the FDIC. Based on capital levels at September 30, 2015, Sound Community Bank was considered to be well-capitalized under applicable regulatory requirements. Management monitors the capital levels to provide for current and future business opportunities and to maintain Sound Community Bank's "well-capitalized" status.

The actual regulatory capital amounts and ratios calculated for Sound Community Bank at September 30, 2015 were as follows (dollars in thousands):

|   | Actual   |        | For Capital Adequacy Purposes |         | To Be Well Capitalized Under Prompt Corrective Action Provisions |          |
|---|----------|--------|-------------------------------|---------|--|----------|
|   | Amount   | Ratio  | Amount                        | Ratio   | Amount   | Ratio    |
| <u>As of September 30, 2015</u>               |          |        |                               |         |  |          |
| Tier 1 Capital to average assets              | \$51,695 | 10.22% | \$20,230                      | > 4.0 % | \$25,287   | > 5.0 %  |
| Common Equity Tier 1 risk-based capital ratio | \$51,695 | 12.87% | \$18,077                      | > 4.5 % | \$26,112   | > 6.5 %  |
| Tier 1 Capital to risk-weighted assets        | \$51,695 | 12.87% | \$24,103                      | > 6.0 % | \$32,138   | > 8.0 %  |
| Total Capital to risk-weighted assets         | \$56,377 | 14.03% | \$32,138                      | > 8.0 % | \$40,172   | > 10.0 % |

For a bank holding company with less than \$1.0 billion in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If Sound Financial Bancorp was subject to regulatory guidelines for bank holding companies with \$1.0 billion or more in assets, at September 30, 2015 Sound Financial Bancorp would have exceeded all regulatory capital requirements. The estimated regulatory capital ratios calculated for Sound Financial Bancorp as of September 30, 2015 were 10.31% for Tier 1 leverage-based capital, 12.98% for both Common Equity Tier 1 risk-based capital, Tier 1 Capital to risk-based assets and 14.15% for total risk-based capital.

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

The Company provided information about market risk in Item 7A of its 2014 Form 10-K. There have been no material changes in our market risk since our 2014 Form 10-K.

### Item 4. Controls and Procedures

#### (a) Evaluation of Disclosure Controls and Procedures.

An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Act")), as of September 30, 2015, was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2015, the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is: (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and the 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.

We intend to continually review and evaluate the design and effectiveness of the Company's disclosure controls and procedures and to improve the Company's controls and procedures over time and to correct any deficiencies that we may discover in the future. The goal is to ensure that senior management has timely access to all material financial and non-financial information concerning the Company's business. While we believe the present design of the disclosure controls and procedures is effective to achieve this goal, future events affecting our business may cause the Company to modify its disclosure controls and procedures.



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The Company does not expect that its disclosure controls and procedures will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. 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. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure 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; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies and procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

(b)Changes in Internal Control over Financial Reporting.

There were no changes in our internal control over financial reporting (as defined in Rule 13a - 15(f) under the Act) that occurred during the three months ended September 30, 2015, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1 Legal Proceedings

In the normal course of business, the Company occasionally becomes involved in various legal proceedings. In the opinion of management, any liability from such proceedings would not have a material adverse effect on the business or financial condition of the Company.

Item 1A Risk Factors

Not required; the Company is a smaller reporting company.

Item 2 Unregistered Sales of Equity Securities and use of Proceeds

(a) Not applicable

(b) Not applicable

(c) The Company did not repurchase any shares of common stock during the three months ended September 30, 2015:

Item 3 Defaults Upon Senior Securities

Nothing to report.

Item 4 Mine Safety Disclosures

Not Applicable

Item 5. Other Information

Nothing to report.

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EXHIBIT INDEX

Exhibits:

- 2.0 Plan of Conversion and Reorganization (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on January 30, 2012 (File No. 000-52889))
- 3.1 Articles of Incorporation of Sound Financial Bancorp, Inc. (incorporated herein by reference to the Registration Statement on Form S-1 filed with the SEC on March 27, 2012 (File No. 333-180385))
- 3.2 Bylaws of Sound Financial Bancorp, Inc. (incorporated herein by reference to the Registration Statement on Form S-1 filed with the SEC on March 27, 2012 (File No. 333-180385))
- 4.0 Form of Common Stock Certificate of Sound Financial Bancorp, Inc. (incorporated herein by reference to the Registration Statement on Form S-1 filed with the SEC on March 27, 2012 (File No. 333-180385))
- 10.1 Employment Agreement by and between Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Registration Statement on Form SB-2 filed with the SEC on September 20, 2007 (File No. 333-146196))
- 10.2 Executive Long Term Compensation Agreement effective August 14, 2007 by and between Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Registration Statement on Form SB-2 filed with the SEC on September 20, 2007 (File No. 333-146196))
- 10.3 Amendment to Freeze Benefit Accruals Under the Executive Long Term Compensation Agreement effective August 14, 2007, by and between Sound Community Bank (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on January 5, 2012 (File No. 000-52889))
- 10.4 Supplemental Executive Long Term Compensation Agreement effective December 31, 2011 by and between Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on January 5, 2012 (File No. 000-52889))
- 10.5 Confidentiality, Non-Competition and Non-Solicitation Agreement by and between Sound Community Bank and Laura Lee Stewart (incorporated herein by reference to the Report on Form 8-K filed with the SEC on January 5, 2012 (File No. 000-52889))
- 10.6 Employment Agreement by and between Sound Community Bank and Matthew Deines (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on November 5, 2009 (File No. 000-52889))
- 10.7 Employment Agreement by and between Sound Community Bank and Matthew Moran (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on November 5, 2009 (File No. 000-52889))
- 10.8 Addendums to the Employment Agreements by and between Sound Community Bank and each of Matthew Deines and Matthew Moran (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on January 3, 2012 (File No. 000-52889))
- 10.9 2008 Equity Incentive Plan (incorporated herein by reference to the Annual Report on Form 10-K filed with the SEC on June 30, 2009 (File No. 000-52889))
- 10.10 Forms of Incentive Stock Option Agreement, Non-Qualified Stock Option Agreement and Restricted Stock Agreements under the 2008 Equity Incentive Plan (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on January 29, 2009 (File No. 000-52889))
- 10.11 Summary of Annual Bonus Plan (incorporated herein by reference to the Registration Statement on Form SB-2 filed with the SEC on September 20, 2007 (File No. 333-146196))
- 10.12

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2013 Equity Incentive Plan (included as Exhibit 10.13 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 and incorporated herein by reference (File No. 001-35633))

10.13 Form of Incentive Stock Option Agreement, Non-Qualified Stock Option Agreement and Restricted Stock Agreement under the 2013 Equity Incentive Plan (included as Exhibit 10.14 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 and incorporated herein by reference (File No. 001-35633))

10.14 Amendment to Clarify Separation of Service Under the Supplemental Executive Long Term Compensation Agreement effective December 31, 2011 by and between Sound Community Bank and Laura Lee Stewart

10.15 Change of Control Agreement dated October 30, 2013, by and among Sound Financial Bancorp, Inc., Sound Community Bank and Matthew P. Deines (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on November 1, 2013 (File No. 001-35633))

10.16 Change of Control Agreement dated October 30, 2013, by and among Sound Financial Bancorp, Inc., Sound Community Bank and Matthew F. Moran (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on November 1, 2013 (File No. 001-35633))

10.17 Settlement Agreement and Release of Claims Agreement between Matthew F. Moran and Sound Community Bank (incorporated herein by reference to the Current Report on Form 8-K filed with the SEC on October 15, 2014 (File No. 001-35633))

11 Statement re computation of per share earnings (See Note 9 of the Notes to Consolidated Financial Statements contained in, Part I, Item 1 of this Quarterly Report on Form 10-Q.)

31.1 Rule 13(a)-14(a) Certification (Chief Executive Officer)

31.2 Rule 13(a)-14(a) Certification (Chief Financial Officer)

32 Section 1350 Certification

101 Interactive Data Files

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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.

Sound Financial Bancorp, Inc.

Date: November 13, 2015 By: /s/ Laura Lee Stewart

Laura Lee Stewart

President and Chief Executive Officer

Date: November 13, 2015 By: /s/ Matthew P. Deines

Matthew P. Deines

Executive Vice President and Chief Financial Officer